CARRYOVER OF NET OPERATING LOSSES AND OTHER TAX ATTRIBUTES OF CORPORATIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

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HOUSE OF REPRESENTATIVES

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CARRYOVER OF NET OPERATING LOSSES AND OTHER TAX ATTRIBUTES OF CORPORATIONS

THURSDAY, SEPTEMBER 22, 1983

U.S. House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 2:17 p.m., pursuant to notice, in room H-137, the Capitol, Hon. Ronnie G. Flippo presiding.

[The press release announcing the hearing follows:]

[Press release of Thursday, September 8, 1983]

Hon. Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Announces a Public Hearing on a Proposal Regarding the Carryover of Net Operating Losses and Other Tax Attributes of Corporations

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced hearings on a proposal regarding the carryover of net operating losses and other tax attributes of corporations to be held on Thursday, September 22, 1983, beginning at 2 p.m. in room H-137 of the Capitol. The lead-off witness at the hearing will be a representative from the Department of the Treasury.

I. BACKGROUND

In the Tax Reform Act of 1976, Congress amended section 382 of the Internal Revenue Code (dealing with limitations on net operating loss carryovers of corporations). Since then, Congress has delayed the effective date of the revisions three times. In general, the revisions are scheduled to become effective after December 31, 1983.

With the effective date of amended section 382 rapidly approaching again, a decision must be made whether to: (1) Let the rules enacted in 1976 become effective; (2) extend the effective date once again; (3) repeal the rules in favor of existing section 382; or (4) adopt some different rules. The adoption of the accelerated cost recovery system (ACRS) in 1981 has increased the importance of these rules. Both the existing section 382 and the amended version have been criticized as being too complex. Both have also been criticized for, on the one hand, reducing or eliminating carryovers in instances where they should perhaps not be reduced or eliminated and, on the other hand, not reducing or eliminating carryovers in instances where they should be reduced or eliminated. Therefore, there is some reluctance either to permit the amended rules to take effect or to return permanently to the existing rules.

For these reasons, the Subcommittee invites testimony on the specific proposal described below. The major features of the proposal borrow heavily from a recommendation of the American Law Institute. The primary rationale of the proposal is that the net operating loss carryovers of a loss corporation should be as available, both in amount and timing, to new owners as they would have been had there been no change in ownership and had the loss corporation invested its assets in an income-generating activity.

II. DESCRIPTION OF THE PROPOSAL

Like present law, the proposal deals separately with two kinds of cases: those in which the loss corporation continues in existence but a majority of its stock is sold or exchanged following the loss year, and those in which the loss corporation is merged with another corporation in a transaction qualifying as a tax-free reorganization or in which ownership in the loss corporation changes as a result of new stock issues.

A. *The purchase rule.*—In situations where control of the loss corporation changes through sales or exchanges of its stock but the loss company continues in existence without any infusion of capital, a "purchase rule" would apply to limit the amount of carried over tax benefits to the amount which could have been used had no change of ownership occurred and the loss company invested the assets it held at the time of the change of ownership in fully taxable assets. This limitation would preclude the new owners of the loss company, by providing the loss company with new income opportunities or new capital that may be difficult to detect or measure, from enjoying greater use of the carried over items than would have occurred in the absence of a change in ownership. Net operating losses incurred by a corporation would be deductible as carryovers after a change in ownership only to the extent of a specified rate of return, reflecting an after-tax yield, on the price paid for the corporations stock. An after-tax rather than a pre-tax rate of return is used to adjust for the fact that the price paid for the loss company's stock reflects both the value of its assets and the value of the tax benefit carryovers. However, net built-in gains that are recognized following the change in ownership could be offset by loss carryovers without limitation. Special provisions would be applied to net built-in deductions.

The limitation would apply only where more than 50 percent of the outstanding stock, by value, of the loss corporation changes hands after a loss year, looking only at persons owning, directly or by attribution, 5 percent or more such stock, by value, in the carryover year. For example, if all the stock of a loss corporation were purchased for $100,000 in a single transaction, the amount of income for the year of purchase and each subsequent year that could be offset by loss carryovers, assuming the rate of return is 10 percent, would be $10,000. To the extent that the limitation exceeds income in any year, the excess would increase the limitation in the following year. If only 80 percent of the stock were purchased by persons each owning actually or constructively 5 percent or more of the outstanding stock, for an aggregate purchase price of $80,000, the limitation under the purchase rule would be 20 percent of taxable income (without regard to the carryover) plus the adjusted rate of return on $80,000. Thus, assuming actual income of $12,000 and the same 10 percent adjusted rate of return, the limitation would be $10,400 (20 percent of $12,000 plus 10 percent of $80,000).

In the case of redemptions, the purchase rule would be applied by treating increases in the percentage held by remaining shareholders in the stock outstanding after the redemption as having been purchased for fair market value, determined with reference to the redemption price.

B. *The merger rule.*—Where the loss corporation is a party to a merger or other tax-free reorganization, carryovers would be allowed to offset income produced by the contribution of the loss company to the capital of the combined enterprise. This approach is intended to provide for the allowability of carryovers to the same extent they would have been allowable if the loss company and the other party to the merger had formed a partnership. In that case, only the loss corporation's share of the income from the partnership could be offset by its carryovers.

Following a merger in which a loss corporation is acquired, loss carryovers of the loss company incurred before the merger would be allowed to offset income of the surviving corporation to the extent that it is attributable to the assets contributed by the loss corporation. The portion of the surviving corporation's income attributable to the loss company's assets is determined by the percentage of common stock of the surviving corporation owned by shareholders of the loss corporation as a result of their ownership of loss corporation stock.

The percentage of taxable income that could be offset by the loss carryovers would be a lesser percentage than the percentage of stock received by loss company shareholders. This lesser percentage is intended to equate with the amount that would constitute the loss company's share of pre-tax income if the loss company and the other party to the merger, rather than merging, had formed a partnership. The rule would be analogous to the determination of the portion of earnings and profits attributable to the loss company's contribution to capital in a merger or other tax-free combination as formulated in the American Law Institute's proposal. It is contemplated that a statutory table will be provided to determine the portion of pre-tax income that may be offset for different percentages of common stock ownership by loss company shareholders. This treatment reflects the fact that to the extent of allowable carryovers, income generated by the loss company is not subject to tax and therefore the percentage of stock received by loss company shareholders will exceed the percentage of pre-tax income derived from the loss company's contribution to the surviving corporation. For example, if loss company shareholders receive 50 percent of the common stock of the surviving corporation following a merger, the percentage of pre-tax income that may be offset by the loss corporation's carryovers would be 35 percent. If the surviving corporation has $100,000 of taxable income (without regard to carryovers) for its taxable year following the merger, the loss carryovers of the loss corporation incurred prior to the merger would be allowed to the extent of $35,000. Thus, taxable income would be $65,000.

If a loss corporation is acquired in a reorganization in which the loss corporation shareholders receive preferred stock, the former loss corporation's net operating loss carryovers deductible in a subsequent year could not exceed the amount paid or declared as dividends on such preferred stock in such year.

C. *New stock issues.*—No limitation will apply if new stock is issued to loss year shareholders on a pro rata basis. New shares otherwise will cause the merger rule to apply by limiting carryovers with reference to the percentage of stock representing continuing interests by loss year shareholder. If new shares issued to loss year shareholders are disposed of, they will be treated as if issued to the transferees.

A de minimis rule would cause no limitation to apply if the fair market value of loss company stock did not increase by more than 20 percent in any 12-month period. Thus, assuming no other new stock is issued within 12 months before or after an acquisition in exchange for stock representing 20 percent by value of the post-acquisition loss company stock outstanding, no limitation would be imposed as a result of such acquisition.

D. *General rules.*—Creditors exchanging debt claims for stock would be treated as receiving shares in a new issue. However, stock received for debt that was held by the creditor in the loss year would be treated as stock outstanding in the loss year.

No limitation would apply in the case of a merger in which the loss corporation and the other corporate party to the merger are owned by the same persons in substantially the same proportions.

Investment tax credit carryovers, foreign tax credit carryovers, capital loss carryovers, and similar carryovers would also be subject to comparable limitation under these rules.

Finally, the Subcommittee invites testimony on the following specific issue: to what extent, if any, should a loss corporation which has converted operating assets to passive investment assets be able to retain or transfer its net operating losses. For example, a loss corporation sells a part or all of its business assets and invests the proceeds in passive investment assets. Should its net operating losses survive a subsequent sale of all its stock with the result that potential acquirers will pay more for the loss corporation than the value of its passive assets, the premium representing payment for the tax benefits? If not, what limitations in addition to those described above should apply?

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler (202) 225-3627 by close of business, Friday, September 16, 1983, to be followed by a formal written request to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This procedure will afford more time for members to question witnesses. In order to expedite the hearing, witnesses may be grouped as panelists with strict time limitations for each panelist.

Requests to be heard must contain the following information:

1. The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);

2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the written record of the hearing.

In order to assure the most productive use of the limited amount of time available to question witnesses, witnesses scheduled to appear before the Subcommittee must comply with the following rules:

1. All witnesses must submit 100 copies of their prepared statement to the full Committee office, Room 1102, Longworth House Office Building, not later than the close of business, Tuesday, September 20, 1983.
2. Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.
3. Not more than five minutes will be allowed for the oral summary.

The Subcommittee wishes to emphasize that failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and may be submitted to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102, Longworth House Office Building, Washington, D.C. 20515, by close of business, Friday, September 30, 1983. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office before the hearing.

Mr. FLIPPO. The subcommittee will come to order.

Today, the subcommittee meets to hear testimony on a proposal regarding the carryover of net operating losses and tax attributes of corporations.

In the Tax Reform Act of 1976, Congress amended section 382 of the Internal Revenue Code, dealing with limitations on net operating losses of corporations. Since then, Congress has delayed the effective date of the revisions three times. In general, the revisions are scheduled to become effective after December 31, 1983.

With the effective date of amended section 382 rapidly approaching again, a decision must be made whether to, one, let the rules enacted in 1976 become effective; two, extend the effective date once again; three, repeal the rules in favor of existing section 382; or four, adopt some different rules.

The adoption of the accelerated cost recovery system [ACRS] in 1981 has increased the importance of these rules. Both the existing section 382 and the amended version have been criticized as being too complex. Both have also been criticized for, on the one hand, reducing or eliminating carryovers in instances where they should perhaps not be reduced, or allowing carryover in instances where they should be reduced or eliminated. Therefore, there is some reluctance either to permit the amended rules to take effect or to return permanently to the existing rules.

The business community has argued that the road to economic recovery lies through accelerated depreciation, investment credits and other tax breaks. However, one consequence of the erosion of the corporate tax base in recent years is that more and more corporations have accumulated, and will continue to accumulate, large loss and credit carryovers.

Unless we do something to reduce trafficking in these carryovers, we will be faced with a tremendous growth in merger activity.

Time, energy and capital that ought to be spent improving productivity and revitalizing American industries will, instead, be spent on mergers and acquisitions. If a corporation can utilize its tax department as a profit center, why should it bother to attempt the difficult task of battling foreign competitors?

The subcommittee is interested in learning whether the proposal put forth in the press release announcing this hearing is not only theoretically sound, but also whether, from a practical point of view, it can be implemented. Therefore, I would encourage witnesses to point out the practical difficulties with the proposal, and at the same time suggest how we might address them. We recognize that modifications in the proposal may be necessary to accommodate any concerns expressed here today.

We would ask the witnesses to summarize their testimony. Your prepared statement will appear in full in the record of today's proceedings. I ask unanimous consent that the press release announcing today's hearing be made part of the record.

Our first witness is the Honorable Ron Pearlman, Deputy Assistant Secretary for Tax Policy of the Department of the Treasury.

Ron, you may proceed in any manner you wish.

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. PEARLMAN. I am pleased to be here today to present the Treasury Department's views on the proposal that is described in the press release. The proposal is designed to change the current limitations on the ability of a corporation to utilize tax attributes such as net operating losses. We are very supportive of the goal of the subcommittee, and in general we are supportive of the underlying theory of the proposal that has been released. We hope the proposal can be transformed into a fair and workable bill that we can ultimately endorse. We are prepared to work with the subcommittee toward that end.

We, too, I might add, Mr. Chairman, are concerned about whether the concepts of the proposal can be put into a workable legislative solution, and we are certainly prepared to put forth our efforts to assist in doing that.

In the interest of time, I am going to proceed directly to a very brief description of the subcommittee proposal, and then try to offer our comments on the proposal and skip some of the background material in my prepared statement.

Under current law and under the Tax Reform Act of 1976 provisions which are not currently effective, section 382 contained and made prominent the so-called continuity of shareholder interest requirement; that is, in general, net operating losses, tax credits, and other tax attributes were reduced, following a taxable purchase transaction or tax free acquisition of a loss corporation by another corporation, to the extent that the loss corporation shareholders did not have the same proportion of equity interest in the acquiring corporation as they had in the loss corporation.

I am going to make references to net operating losses, Mr. Chairman, but I will use that as a shorthand to include the other tax attributes that are covered by the same rules.

Unlike present law, or the 1976 act amendments, the proposal that is being considered by the subcommittee does not reduce the amount of carryovers that can be utilized by an acquiring corporation following the acquisition. Indeed, it allows the entire loss to carryover and then determines what portion of the income following the acquisition can be offset by the loss.

In general, then, the proposal would permit the use of a loss corporation's net operating losses following either a taxable acquisition or a tax-free acquisition to the same extent as would have been possible if the ownership of the corporation, the loss corporation, had not changed hands. The way the proposal seeks to do that is to articulate two sets of rules, one for purchases and the other for tax-free acquisitions. Those rules are very much different from the two sets of rules that are contained in present law.

Before turning to the details of the proposal, I would like briefly to refer to certain tax and economic policy considerations, some of which indeed are inconsistent with each other, but all of which we think should be recognized, even if not strictly followed, in establishing carryover rules.

First, I do not think any of us should lose sight of the original legislative objective of the net operating loss and attribute carryover rules, which was to avoid the arbitrariness of the annual accounting concept by providing an averaging device through which a business's profits in 1 year and losses in another could be combined.

Second, we think the carryover rule should be as economically neutral as possible. To the extent possible, we do not want to distort investment decisions. We do not want to favor diversified over nondiversified businesses, or vice versa; start up businesses over established businesses, or vice versa; or purchasers of loss corporations over sellers.

Third, net operating losses are not intended to be used as a Government subsidy. We do not think the Government should, through a system of refundability or free transferability, become a partner in a loss business.

Fourth, the carryover rules should not encourage trafficking in net operating losses, a point you made in your introductory statement, Mr. Chairman. We do not want a set of rules that will encourage loss corporations to be bought and sold solely for the benefit of the net operating loss carryovers. We want to articulate a set of rules that makes the nontax business purposes for a purchase and sale preeminent.

Finally, as I would assume we would all agree, we should strive for certainty in the determination of the extent to which tax attributes will survive a change in ownership, so that buyers and sellers, and the Internal Revenue Service, all can deal with the known rather than the unknown.

I mentioned previously that present law and the 1976 amendments to section 382 rely heavily on the so-called shareholder continuity test. In fact, if one accepts, for purposes of section 382, the continuity of shareholders test, it is well to understand its precise definition. For this purpose, what we mean by continunity of shareholder interest is a continued economic interest of the shareholders of the loss corporation in that corporation or in its successor in a taxable year subsequent to the time the losses were incurred.

The 1954 Code and the 1976 act amendments rely heavily on this standard. Indeed, the 1976 amendments go further and make the shareholder continuity test the sole test in determining the extent to which the net operating loss can be carried over. We do not think that reliance on the shareholder continuity test in determining the amount of the loss that survives is appropriate for two reasons.

First, the continuity of shareholder interest test may be inconsistent with the original purpose of the net operating losses provision, which is to average income and loss over a period of time. Indeed, shareholder continuity may be irrelevant to the averaging concept.

Second, the shareholder continuity test contributes to a lack of neutrality in the case of a potential purchase of a loss corporation. For example, a large corporation may be less interested than a smaller prospective purchaser in acquiring a loss corporation, because after an acquisition by the large corporation, the shareholders of the loss corporation would represent a smaller portion of the surviving corporation, and thus a smaller portion of the net operating loss would survive.

In view of what we perceive as the inadequacy of both existing law and the 1976 amendments, we are anxious to work with the subcommittee in exploring possible alternatives. One alternative that has been suggested is the so-called pool of capital approach. The basic principle of this approach is that the entire net operating loss carryforward is preserved after a loss corporation is acquired, but a limit is imposed on the amount of annual earnings against which that loss can be deducted. The limit generally is based on a presumed income stream from the assets owned by the loss corporation.

There are at least two ways in which a pool of capital approach could be applied. One way is to apply different rules to tax-free and taxable transactions. In a tax-free transaction, postacquisition earnings would be apportioned based on the extent to which the loss corporation's former shareholders owned stock in the acquiring corporation. In purchase transactions, postacquisition earnings would be apportioned by looking at the purchase price paid for the loss corporation's assets, and then applying a specific rate of return to that price.

The purchase rule probably represents the furthest departure from a shareholder continuity test. In the purchase rule, you do not look to shareholder continuity at all; you look to the purchase price of the stock that was acquired.

An alternative approach which still seeks to utilize the pool of capital concept, would be to apply a single rule to both tax-free and taxable transactions. A single rule would look solely to the purchase price of the loss corporation as the basis for identifying the permissible segment of postacquisition earnings that could be offset in both tax-free and taxable transactions.

We are attracted to the idea of a single rule, but this alternative would impose no limitation on when the net operating loss carryforward could be utilized. We think the absence of such a limit produces the unsatisfactory result of permitting the surviving corporation to use the entire loss or other tax attribute in the taxable year immediately following the acquisition.

Now I would like to offer some specific comments on the subcommittee's proposal.

The purchase rule seeks to limit the utilization of the loss carryforwards to the income the loss corporation would have earned had it not been sold, and had it begun an earnings history at the time of the sale. The rule creates a hypothetical income stream by imputing an assumed rate of return on the value of the corporation's assets, which is presumed to be equal to the purchase price of the stock acquired.

If the change in ownership of the loss corporation is 50 percent or less, then the purchase rule in the proposal imposes no limitations on the continued availability of net operating losses carryforwards. On the other extreme, if 100 percent of the ownership changes, then the earnings usable against the net operating loss carryforward would equal the purchase price times an assumed rate of return.

If a change of ownership between 51 and 99 percent occurs, then the portion of the earnings attributable to the stock that was not sold can be fully offset by the net operating loss carryforward, while the portion of the earnings attributable to the stock that was sold could be offset by the net operating loss carryover only to the extent of the purchase price factored by an assumed rate of return. So, in the 51 to 99 percent case, you have a hybrid application of the purchase price rule.

We think the theory of the purchase price rule is sound, but we do want to point out several practical problems which we perceive.

First, we would hope that if the purchase price rule is adopted in the form presented in the proposal, that a specific rate of return would be adopted. We believe that a specific rate is preferable to a year-by-year fluctuating rate of return. Use of a specific return will achieve one of the objectives we suggested at the outset, namely, giving certainty at the date of the sale to the valuation of the loss corporation stock, and it will, in a sense, equalize the negotiating posture of the buyer and the seller.

Second, the rate of return is itself an arbitrary concept. It means that the legislation or a regulation is going to have to adopt a rate of return, and obviously reasonable people could differ as to what that rate of return should be. We suggest that the subcommittee should at least consider the possibility, as an alternative, of an approximation of a precise rate of return on assets. Such an approximation could be determined based on the purchase price of the loss corporation stock, perhaps after applying an appropriate discount rate, and an amortization period over which the net operating loss carryforward could be used.

We would want to make sure, of course, that the technical rules developed to implement a purchase price concept would achieve congressional intent and would not, in practice, permit taking undue advantage of the carryforwards.

Now I would like to turn to the second part of the proposal, which deals with the rules applicable to tax-free reorganizations, the so-called merger rule. Here, the proposal assumes that the loss corporation and the acquiring corporation combine in a joint venture to which they contributed their assets.

The proposal seeks to identify the portion of the joint venture's income which would be available for offset against the loss corporation's net operating loss. The appropriate portion of the joint venture's income would be based on a percentage of the participating stock, typically common stock, in the acquiring corporation which is issued to the loss corporation shareholders.

The percentage of income that would be eligible to be offset against the net operating loss would be smaller than the percentage of stock issued to loss corporation shareholders to reflect the fact that a portion of the postreorganization income allocable to the loss corporation would be offset against the net operating loss carryforward and, therefore, would not be subject to tax. As a result of that tax benefit, in the negotiation of the acquisition, more stock would be issued to the loss corporation shareholders than the actual percentage of pretax income allocable to the loss corporation's assets.

If the loss corporation shareholders received only preferred stock with a fixed market rate yield, the net operating loss could be used only to the extent of dividends paid or accrued on the preferred stock.

We think the merger rule might work well if only common stock or fixed rate preferred stock were issued. However, in a more complicated transaction, such as when hybrid securities are issued, the merger rule must give way, as indeed the proposal acknowledges, to the purchase rule. Because of this fact, we think the subcommittee should consider whether two sets of rules really are justified.

In the interest of simplification and consistency, perhaps the purchase rule should be applied to all transactions. Admittedly, valuation of stock received in the merger would be necessary if the purchase rule were applied to tax-free transactions. However, such valuation problems will be encountered in mergers with hybrid securities anyway, and valuation may not be a particularly difficult task in the more straightforward merger transactions.

Now I would like to mention two more items very briefly.

First, we agree with the subcommittee proposal to impose no limitation on net operating loss carryforwards if the loss corporation issues stock to its historic shareholders on a pro rata basis in exchange for their cash or property. We do hope, however, that the subcommittee will consider the tax and the economic implications of imposing limitations on net operating loss carryforwards, as the proposal suggests, when the loss corporation issues stock to third parties. While this limitation is theoretically consistent with the pool of capital approach, the limitation may well force loss corporations to incur debt as a way to raise capital rather than seek new equity. This will put pressure on the debt-equity rules, which we certainly wish to avoid. Moreover, such a limitation may well discourage the efforts of loss corporations to rehabilitate themselves.

The second point I want to mention has to do with so-called investment assets. In the news release announcing the proposal, the subcommittee invited testimony on the question of whether a loss corporation which has converted operating assets to passive investment assets should be able to retain or to transfer net operating losses incurred with respect to the operating assets. We believe that in theory such a corporation generally should be able to retain and transfer its net operating loss carryforwards to the same extent as a corporation that has primarily operating assets.

In the context of a pool of capital approach, it is difficult for us to distinguish between a loss corporation that continues to own operating assets and one that has converted those assets into passive investment assets. However, the unlimited ability to sell a corporation, the assets of which are only investment assets and net operating loss carryforwards, might be perceived as being inequitable and thus might affect the public's view of the tax system.

We recognize, moreover, that the ability to convert business assets into investment assets prior to a purchase or reorganization might in certain circumstances permit abusive transactions. Thus, if such corporations are allowed to transfer net operating loss carryforwards, we would like to work with you to develop safeguards that are deemed necessary to prevent abuse of the rules.

We think that the proposal advanced by the subcommittee represents a very positive start toward resolving the difficult problems that have arisen with respect to limitations on the utilization of net operating loss carryforwards and other tax attributes. The 1976 act proposals apparently were enacted without the benefit of hearings, and we compliment the subcommittee on its decision to conduct these hearings. We hope that the development of the subcommittee's proposal will be viewed as evolutionary. As the chairman indicated in his opening statement, no one, including the Treasury Department, should blindly oppose changes in the proposal as the evolutionary process continues. We look forward to working with the subcommittee in refining the proposal, and in developing an effective and workable legislative solution.

This concludes my prepared remarks, Mr. Chairman, I will be happy to try to respond to your questions.

Mr. GUARINI [presiding]. Thank you very much for your fine presentation, Mr. Pearlman.

Mr. Duncan.

Mr. DUNCAN. I have no questions. I simply want to thank Mr. Pearlman.

Mr. GUARINI. Is there any favoritism that would be in your approach toward purchases as opposed to mergers? Do you find any bias in the proposal?

Mr. PEARLMAN. I think that I would rather answer your question under the general proposal that was put forth by the subcommittee, by saying that we would hope that the evolution of the rules would try to maintain a neutrality between purchase transactions and tax-free transactions. One of the reasons that we suggested the possibility of adopting a single rule that would apply to both types of transactions is that such a rule would assure—as much as one could—that no preference would be given to either the purchase transaction or the merger transaction.

My comment regarding consistency was designed to deal with that issue, and we believe, Mr. Chairman, that that is an issue that the subcommittee and the drafters are going to have to examine. We think that there should be no preference given to one type of transaction or the other.

Mr. GUARINI. If you set an appropriate rate of return, there would be built into that system a differential?

Mr. PEARLMAN. I guess an economist would say to you, if you set an appropriate rate of return that fluctuated with the market and if the purchase price of the stock accurately reflects rates of return, I think you would conclude that they should come out neutral.

I think we have some concern that in the real world that will not happen. Indeed, we are suggesting that if you are going to give any certainty to a concept of rate of return, you should set a specific rate of return, and you cannot let people sit out there not knowing today, when they negotiate the sale of the business, what the rate of return is going to be 5, 7, or 10 years down the road. We see some problems with such uncertainty which may, indeed, detract from the kind of neutrality that was implicit in your question.

Mr. GUARINI. What about a level playing ground between passive and active income, the limit on business assets as opposed to other types of asset income?

Mr. PEARLMAN. We think that conceptually, and indeed I think I would go further and say as a matter of fairness, that there should be a level playing field between the corporation that has operating assets and that is sold subject to the carryover rules, and a corporation that has only investment assets.

Mr. GUARINI. Philosophically, you don't have any trouble with that?

Mr. PEARLMAN. Let me go on. Philosophically, I would say, no, I do not have any problem with that for a specific reason. In general, if a corporation sells its assets and converts the cash into investment assets, then it can use its loss carryovers to offset that investment income. So, conceptually, the question is, why should that be any different when, instead of having the corporation sell the operating assets, obtain cash, and reinvest the proceeds, the shareholders sell the stock of that corporation.

I think we are concerned however, about public perception, and we are concerned about abuse. We certainly want to make sure, one, that we do not create the wrong impression by permitting losses to be offset against investment assets after a sale; and two, that by creating a rule that does permit losses to be offset against income from investment assets that we do not create a vehicle whereby sellers can, in effect, design a so-called free transferability system. That is, if a corporation sells its operating assets, gets cash, and reinvests that cash in certificates of deposit or some other cash equivalent to produce income, and then someone buys its stock, the purchaser then has a net operating loss and a pool of cash. He could easily spend the cash and be left with just net operating losses, which one might argue is the same as if the corporation had sold just the net operating loss up front.

So I think we want to look at that kind of transaction. We want to have some kind of restrictions. There may have to be subjective restrictions, such as the present tax avoidance test that is in the code to try to deal with the abusive transactions.

I would hope the subcommittee would not overreact to the abusive transaction, however, and say, because there is potential for abuse, that the conceptual underpinning of the pool of capital approach means that the investment asset transaction is totally unacceptable. We would hope that there is a blend there that would permit certain transactions to go forward even if only investment assets were owned by the loss corporation.

Mr. GUARINI. This pool of capital approach, does it have the support of the various tax institutes, the American Bar Association, and other tax people?

Mr. PEARLMAN. The bar associations, I am sure, will make their views known to you today, and I certainly do not want to speak for them. The pool of capital approach is an approach that has been developed after a considerable effort and input by a large number of people involved in the study of the carryover of tax attributes undertaken by the American Law Institute.

I think it is fair to say that it is through the American Law Institute's efforts that a variety of tax experts and persons knowledgeable in corporate taxation were brought into the process. Indeed, the pool of capital approach is the approach proposed by the American Law Institute, and we believe it is a very well-thought out and a well conceived approach.

We might not agree on all the details, but in concept we believe that it does serve as a good basis for developing a sound set of rules.

Mr. GUARINI. I want to thank you very much, Mr. Pearlman, you have been of great help. You have given a very fine presentation. if we have any further questions we want to ask, perhaps we can do it in a letter or some other way.

Mr. PEARLMAN. We will be happy to try to answer your questions.

Thank you, Mr. Chairman.

Mr. GUARINI. Thank you.

[The prepared statement follows:]

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee, I am pleased to appear before you today to present the views of the Treasury Department of a proposal to change the current limitations on the ability of a corporation to utilize tax attributes, such as net operating losses and certain tax credits, in years following certain corporate transactions. The proposed changes are intended to reduce the incentive effect these tax attributes have on corporate acquisitions.

The Treasury Department supports the goal and, in general, the underlying theory of the proposal. We hope that the proposal can be transformed into a fair and workable bill that we can ultimately endorse.

BACKGROUND

Under current law, a corporation that incurs a net operating loss in one year generally is permitted to use the loss to offset income earned in the three taxable years prior to and the fifteen years after the year in which the loss is incurred. The underlying premise of allowing a corporation to offset a net operating loss incurred in one year against taxable income earned in another year is to provide an averaging device to ameliorate the unduly harsh consequences of a strict annual accounting system.

Section 382 was added to the Internal Revenue Code in 1954 to establish objective tests that would curb "trafficking" in corporations with unused net operating losses. Congress was particularly concerned that certain corporations were acquiring shell corporations whose principal asset was a net operating loss that could be applied in future years against income unrelated to any business activity of the acquired corporation.

In addition to the specific objective limitations contained in section 382, the carryover of net operating losses may be disallowed under section 269 if the principal purpose of an acquisition of stock or assets is to secure the benefit of the net operating losses. Thus, section 269 is available to prevent misuse of the general carryover provisions.

In the Tax Reform Act of 1976 ("1976 Act"), Congress sought to tighten and make uniform the provisions of section 382. The 1976 Act amendments were enacted in part because Congress believed that section 382 was ineffective and did not adequately serve its purpose. The effective dates of the 1976 Act amendments have been delayed in response to criticism, however. The 1976 Act amendments are currently scheduled to become effective on January 1, 1984, in the case of tax-free reorganizations, and on June 30, 1984, in the case of taxable stock purchases.

Section 382, both as presently in effect and as modified by the 1976 Act, incorporates two sets of rules for limiting the utilization of net operating losses. One set of rules applies in cases of changes of stock ownership by purchase and the other set of rules applies to certain tax-free reorganizations.[1]

Purchase rule

Under existing section 382, the carryover of net operating losses, in the case of acquisitions by purchase, is denied entirely if (1) more than 50 percent of the stock of the corporation that incurred the loss ("loss corporation") changes ownership by purchase within two taxable years and (2) the loss corporation does not continue to carry on substantially the same trade or business after the change in stock ownership. Thus, in a transaction in which stock is sold or redeemed, the carryover of net operating losses is prohibited if there is both (1) insufficient "continuity of interest" by the loss corporation's shareholders and (2) insufficient "continuity of business enterprise" after the stock purchase.

The 1976 Act amendments, in the case of taxable acquisitions, removed the requirement that the historic trade or business of the loss corporation be terminated before limitations on carryovers would be imposed. Thus, the focus of section 382 was shifted solely to changes in stock ownership. The 1976 Act amendments also raised the threshold change of stock ownership to 60 percent in the case of stock purchases. This increase in the threshold from 50 percent to 60 percent was enacted to coordinate the rules applicable to purchases with those applicable to reorganizations. In addition, rather than eliminating all net operating losses once the required change in stock ownership has occurred, net operating loss carryovers under the 1976 Act are gradually phased out as the percentage change in stock ownership increases.

Reorganization rule

Under section 382 as presently in effect, the carryover of net operating losses generally is limited in the case of certain tax-free reorganizations if the stock in the acquiring corporation received by shareholders of the loss corporation after the acquisition is less than 20 percent of the stock of the acquiring corporation. In such a case, the net operating loss carryovers of the loss corporation are gradually reduced based upon the level of the loss shareholders' ownership in the acquiring corporation.

Under the 1976 Act, the types of tax-free reorganizations to which section 382 applies were expanded significantly to prevent avoidance of the limitation. Moreover, the level of stock ownership at which net operating loss carryovers are limited was increased by the 1976 Act from 20 percent to 40 percent. If the shareholders of the loss corporation acquired at least 40 percent of the acquiring corporation's stock, the net operating losses would be allowed in full. If, on the other hand, the loss corporation's shareholders acquired less than 40 percent of the stock of the acquiring corporation in such a tax-free reorganization, the net operating losses available to the acquiring corporation would be phased out as the loss corporation shareholders' percentage ownership in the surviving corporation declined.

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[1] An identical set of rules is provided in section 383 to limit the use of corporate tax attributes other than net operating losses, such as investment tax credit carryovers, foreign tax credit carryovers, and capital loss carryovers, following an acquisition. For convenience, we will refer in our discussion primarily to net operating loss carryovers. Many of the same principles, however, apply to virtually all corporate tax attributes.

SUMMARY OF PROPOSAL

Unlike the existing section 382 or the 1976 Act amendments, the proposal being considered by the Subcommittee does not determine the reduction of the amount of the carryovers that can be utilized by an acquiring corporation according to the extent of the continuing ownership of the loss corporation's shareholders. Rather, it seeks to allow loss carryovers to be used to offset the income the loss corporation would have earned. In addition, like the 1976 Act amendments, the proposal eliminates the continuity of business enterprise requirement.

The proposal borrows heavily from the recommendations made by the American Law Institute. In general, the proposal would permit the use of a loss corporation's net operating losses, following a taxable stock acquisition or a tax-free reorganization, to the same extent as would have been possible if ownership of the loss corporation had not changed hands. The proposal, like existing law and the 1976 Act amendments, includes two sets of rules, one applying primarily to cases in which the stock of the loss corporation is acquired by purchase and a second applying to cases in which the assets of a loss corporation are acquired in certain tax-free reorganizations.

DISCUSSION.

Before discussing the proposal in greater detail, it is useful to outline briefly the theoretical underpinnings of limitations on the carryover of net operating losses and other tax attributes following the acquisition of a corporation. It also is useful to describe generally the criticism that has been made in response to existing law and the 1976 Act amendments.

In analyzing the issues raised by the carryover of corporate net operating losses, commentators have suggested the following competing, and somewhat inconsistent, tax and economic policy considerations:

"any rule governing the carryover of tax attributes should be consistent with the historic legislative purpose of the carryover provisions as averaging devices;

"the tax laws should not unduly distort investment decisions and should not create undue bias between diversified and non-diversified entities or between old and new businesses;

"a corporation's ability to carryover net operating losses should not require the Federal government to be a partner in all businesses. In other words, the rules governing the use of net operating losses should not amount to a Federal subsidy for all such losses;

"the rules applicable to the carryover of tax attributes should prevent 'trafficking' in loss corporations;

"any limitations on the carryover of net operating losses and other tax attributes to the extent possible should not result in tax attributes of a corporation becoming more valuable in the hands of a purchaser of the corporation than they would have been in the hands of the seller;

"the tax laws should not encourage corporate acquisitions that would not be undertaken on purely economic terms;

"the rules establishing limitations on carryovers also should provide certainty in determining the extent to which tax attributes will survive an acquisition to prevent a purchaser from obtaining a windfall from the carryover."

As is apparent from these principles, the initial question that must be faced is whether any limitations should be imposed on the use of net operating losses. One can argue that the rules governing the use of net operating losses will not create a bias among various types of entities and businesses and will not distort investment decisions only if all limitations are removed from the utilization of such losses. The furthest move in this direction would be to provide for refundability of net operating losses. In a refundability system, a corporation that incurred a net operating loss would receive a refund from the Federal government equal to the tax savings that would have resulted if the corporation had been able to offset fully the net operating loss in the current year against other income.

A provision for direct reimbursement of net operating losses by the Federal government would, of course, eliminate trafficking in corporations that contained unused net operating losses, one of the perceived abuses section 382 is designed to prevent. Moreover, such a system would ensure that the benefits of a net operating loss would accrue directly to the entity that suffered the loss.

The adoption of a refundability system also would eliminate the current bias in favor of conglomeration that exists with respect to the deductibility of net operating losses. This bias exists because net operating losses of one business may be offset against profits of another business, thereby reducing the conglomerate's current tax burden. By comparison, a corporation engaged in a single line of business does not receive any tax benefit from a net operating loss until and unless that corporation realizes offsetting income. On a present value basis, such a net operating loss is worth less than a net operating loss that is usable currently. A reimbursement system would eliminate this bias by providing the same after-tax consequences for a net operating loss regardless of the existence of a related profitable enterprise.

Similarly, the current treatment of net operating losses is biased in favor of established enterprises, with respect to undertaking new investments. An established corporation that incurs a loss on an investment may secure an immediate refund under current law by applying that loss against past taxable profits. A new corporation, by contrast, is unable to utilize a net operating loss until it realizes taxable income. A system of refundability aslo would eliminate this bias by equalizing the treatment between new and existing businesses in the event of a loss.

While a system of refundability might well make the net operating loss provisions more neutral among various types of enterprises, we do not believe it is possible to implement such a proposal. A system of refundability would require the Federal government to become a partner in all investments, a role we believe is inapproporiate. Moreover, a system of refundability would pose potentially insurmountable administrative and budgetary problems. For example, verification of the bona fide value of the net operating losses would be imperative, yet extremely difficult, complex and, perhaps, impossible.

Short of providing direct government reimbursement of net operating losses, it can be argued that all limitations on the carryover of tax attributes from one corporation to another, such as section 382, should be repealed. While the resulting system, which can be described as free trafficking in corporations with favorable tax attributes, would not achieve complete neutrality, it would ensure that most of the benefit of the net operating losses would be realized by those who suffered the economic losses. Consequently, purchasers of loss corporations would not be able to realize windfall profits at the expense of loss corporations or their shareholders.

The argument in favor of unrestricted trafficking in loss corporations, however, goes far beyond the legislative purpose of permitting a corporation to offset a net operating loss in one year against taxable income in another year as an averaging device so that the inequity of a strict annual accounting system can be avoided. Unrestricted trafficking in loss corporations also would result in a partial and indirect reimbursement of such losses because profitable corporations, rather than paying tax, could purchase net operating loss carryovers from loss corporations and use those carryovers to offset taxable income. Thus, substantial revenue losses would result. As stated above, we do not believe that the carryover rules were intended to serve the function of providing Federal subsidies, whether direct or indirect, for corporate losses.

Although we recognize that both refundability and the unrestricted trafficking in loss corporations might make risk-taking in corporate form more attractive, it is not clear that risk-taking is relatively discouraged under existing tax rules. The unrestricted ability to use corporate tax attributes, including net operating losses, also would incourage the takeover of loss corporations by profitable ones primarily to obtain the tax benefits of net operating loss carryovers. Such tax-motivated mergers and acquisitions may have adverse effects on the economy and should not be encouraged.

Alternate bases for limitations

Accepting, as we do, that the transferability of unused net operating loss carryovers should be limited, it is necessary to examine the various bases upon which such a limitation may be imposed. The bases for limiting net operating loss carryovers that have been used in the past are continuity of shareholder interest and continuity of business enterprise.

For purposes of section 382, continuity of shareholder interest may be defined as the continued economic interest of the shareholders of the loss corporation in that corporation or its successor during the taxable years subsequent to the years in which the net operating losses were incurred. Since its enactment in 1954, section 382 has considered continuity of shareholder interest a significant factor in determining whether, an the extent to which, the carryover of net operating losses should be limited. Moreover, the 1976 Act amendments to section 382 established continuity of shareholder interest as the sole factor to be considered in determining the limitation on net operating loss carryovers following a change in ownership of the loss corporation.

The rationale for using continuity of shareholder interest as the basis for limiting carryovers is that a corporation's shareholders generally are the real parties who suffer economic loss when the corporation they own incurs a net operating loss. The loss carryover thus should be deductible by the corporation only if such a deduction will reduce the shareholder's economic loss.

We believe that reliance on continuity of shareholder interest as a determinative factor for limiting carryovers, particularly as the sole factor as set forth in the 1976 Act amendments, is subject to serious criticism. First, a limitation based on continuity of shareholder interest may be inconsistent with the income averaging function of the net operating loss carryover provision. For example, net operating losses frequently result from a corporation's ability to deduct expenses prior to the year in which corresponding items of income must be reported. This mismatching of income and expenses frequently occurs in the case of assets that are subject to the accelerated cost recovery system. To the extent that net operating losses result from this mismatching of expenses and income, the lack of continuity of shareholder interest should not limit the ability of the business to use its net operating losses to offset income in subsequent taxable years.

Second, a limitation based on a specified percentage of continued shareholder interest may create undesirable economic effects. For example, if shareholders of the loss corporation are required to own a minimum precentage of the stock of the surviving corporation, a relatively large corporation, because it would be denied the use of otherwise available net operating loss carryovers, might be motivated to pay less for such a loss corporation than would a smaller potential purchaser. Certain acquisitions might thus be discouraged even though desirable without regard to tax considerations. We believe economically motivated acquisitions should not be unduly penalized by the tax laws.

The second factor upon which the limitation on the carryover of net operating losses has been based is continuity of business enterprise. Under the continuity of business enterprise test, limitations are imposed on the carryover of net operating losses if the business conducted by the loss corporation is not continued by the acquiring corporation.

The continuity of business enterprise doctrine, as a test to determine the availability of net operating loss carryovers, suffers several serious flaws. First, the continuity of business enterprise test is difficult to apply whenever significant new capital or other assets are added to the old busienss, or where the old business is operated in a different manner. This uncertainty has resulted in costly and time-consuming litigation, without clarifying the ambiguous nature of the standard. Such uncertainty causes purchasers of loss corporations to reduce the price they offer and gives them an opportunity to realize a windfall profit at the expense of the loss corporation and its shareholders. Thus, the intended beneficiaries of the provision do not properly benefit from the carryover of the net operating losses by the acquiring corporation.

Second, using continuity of business enterprise as a means to limit the utilization of net operating loss carryovers encourages a loss corporation, or a corporation that purchases the loss corporation, to continue operating an unprofitable business. Such uneconomic behavior should not be encouraged by the tax laws.

Third, even if the continuity of business enterprise test is met, the continuing business may be an insignificant part of the surviving corporation or produce no income, yet the new operating losses incurred prior to an acquisition can be used in full. Such a result, which in the extreme will be tantamount to free transferability of net operating losses, may be unsatisfactory.

The existing rules of section 382, which rely on both continuity of business enterprise and continuity of shareholder interest, suffer the same defects as their theoretical underpinnings discussed above. Moreover, we believe that existing law is deficient because many corporate acquisitions can be structured to avoid the application of the section 382 limitations in situations in which there may be no substantial business purpose other than utilization of the new operating loss of the acquired corporation. While section 269 can be used to curtail such acquisitions, existing section 382 inadequately serves its purpose when its provisions can be so easily avoided.

The 1976 Act, in an attempt to create a more effective set of rules, eliminated the continuity of business enterprise requirement, coordinated the treatment of acquisitions by purchase and reorganizations and tightened the rules to prevent avoidance. The rules enacted in 1976, however, have been criticized for their complexity. While complexity in the tax laws should be avoided whenever possible, it is justified if the rules are necessary, theoretically correct, and effective. We believe, however, for the reasons stated above, the sole reliance on continuity of shareholder interest is neither necessary nor theoretically correct.

In view of the inadequacy of both existing law and the 1976 Act amendments, we are anxious to work with the Subcommittee in exploring possible alternative methods of limiting the utilization of net operating losses. One alternative that has been suggested is the so-called pool of capital approach. The basic principle of this approach is that the entire net operating loss carryover is preserved after a loss corporation is acquired, but a limit is imposed on the amount of annual earnings against which the net operating loss can be deducted. The limit in general is based on the presumed income stream from the assets owned by the loss corporation.

In the case of tax-free mergers, the pool of capital approach can be applied by allowing loss carryovers to offset only post-merger earnings allocable to stock held by shareholders as a result of stock ownership in the loss corporation. In the case of purchase transactions, the approach can be applied by permitting the net operating loss carryover to be offset only against earnings of the purchases equal to a specified rate of return on the price paid for the loss corporation's assets.

An alternative application of the pool of capital approach, which has been suggested, would limit net operating loss carryovers available after either a taxable purchase or a tax-free reorganization to an amount equal to the purchase price of the loss corporation. A virtue of this alternative is the fact that a single rule could be applied to all types of transactions, a laudable attempt to simplify the pool of capital approach. By limiting only the total amount of net operating loss carryovers that would survive a purchase or reorganization, however, this alternative would not impose any limitation on the timing of the new operating loss carryovers available to the surviving corporation. Thus, under this alternative, the entire new operating loss could be deducted by the surviving corporation in the taxable year immediately following the acquisition.

DETAILED ANALYSIS OF THE PROPOSAL

The proposal currently being studied by the Subcommittee, like existing law, involves one set of rules for purchase transactions and a second set of rules for certain reorganizations. The mechanics of the proposal, however, are quite different from existing law.

Purchase rule

The purchase rule provides in general that in any case in which the ownership of the outstanding stock of a loss corporation is purchased after a loss year, the subsequent deduction of new operating loss carryovers is limited, as to both timing and amount, to the income the loss corporation would have earned had no change of ownership occurred and had the loss corporation begun to earn taxable income at an assumed rate of return on the assets it owned at the time of the purchase.

Under the proposal, no limitations on net operating loss carryovers would be imposed unless more than 50 percent of the outstanding stock changed ownership after a loss year. In determining whether changes in the corporation's ownership were sufficient to invoke the rule, only shareholders who owned five percent or more of such stock in the carryover year, directly or by attribution, would be considered.

If 100 percent of the stock of a corporation is purchased, the deduction of net operating loss carryovers for each subsequent taxable year would be limited in amount to an assumed rate of return times the purchase price of the stock. The proposal specifies that the assumed rate of return would be an after-tax rate to reflect the fact that the post-acquisition profits of the loss corporation would not be subject to tax to the extent that the income would be sheltered by the unused net operating losses. If more than 50 percent but less than 100 percent of the loss corporation's stock were purchased, the portion of the acquiring corporation's income attributable to the stock that had not been sold could absorb net operating loss carryover deductions without limitation. The remaining portion of the earnings attributable to the stock that had been purchased could be offset only in an amount equal to the assumed return on the purchase price of that stock.

We support the theory underlying the proposed purchase rule; however, we believe it entails some practical problems. If the assumed rate of return used in the calculation of the limitation varied from year to year, potential sellers and purchasers of a loss corporation's stock would be forced to predict future fluctuations in the rate of return to determine the economic benefit inherent in the tax attribute, thereby making quite difficult the date-of-sale market valuation of the stock of the loss corporation. We believe that such uncertainty, like the uncertainty present in existing law regarding the continuity of business enterprise test, generally will benefit the purchasers of loss corporation stock, who will insist on discounting the net operating loss carryovers. Thus, the corporation and shareholders that suffered the economic loss will not benefit fully from the potential net operating loss deductions, and the acquired corporation will realize an unjustified profit.

It is possible that the goals of the purchase rule might be realized, while avoiding many of the problems raised by a rate of return, by using a mathematical approximation in lieu of the precise return on net assets. One alternative formulation of the purchase rule would limit the net operating loss carryovers of the loss corporation that could be used annually by the acquiring corporation to an amount equal to the purchase price of the loss corporation's stock, perhaps after applying an appropriate interest rate, amortized over an appropriate period.

We are concerned that the interplay of the many technical provisions in the proposal might permit avoidance of its intent. We believe, therefore, that care must be taken to ensure that manipulation of the purchase rule does not enable avoidance of the limitations on the carryover of corporate tax attributes. We would be pleased to work with the Subcommittee in formulating rules that would eliminate such possibilities.

Merger rule

Under the proposal, in any case in which a loss corporation is acquired for stock of the acquiring corporation in a tax-free reorganization, the net operating loss carryovers otherwise available would be allowed to offset only the portion of income earned after the acquisition that is allocable to the contribution of the loss corporation's assets to the acquiring corporation. This merger rule is intended in principle to permit the use of net operating loss carryovers to the same extent that such carryovers would have been allowed if the loss corporation and acquiring corporation had contributed all of their assets to a joint venture. The proposal attempts to duplicate the fact that under such circumstances, only the portion of the joint venture's income allocable to the loss corporation could be offset by that corporation's net operating loss carryover.

After a reorganization to which the merger rule applies, the portion of the post-acquisition income allocable to the loss corporation's assets would be determined by reference to the percentage of "participating" stock of the acquiring corporation issued to the loss corporation's shareholders in the acquisition. The percentage of the acquiring corporation's income that could be offset, however, would be less than the percentage of participating stock of the acquiring corporation issued to the loss year shareholders in the acquisition. The reduction is necessary because post-reorganization income theoretically allocable to the loss corporation would not be subject to tax to the extent of allowable net operating loss carryovers. As a result, the percentage of the acquiring corporation's participating stock that would be issued in the acquisition generally would exceed the percentage of pre-tax income of the acquiring corporation allocable to the loss corporation's assets.

The percentage of income that could be offset would be set forth in a statutory table keyed to the percentage of the participating stock of the acquiring corporation issued to the loss shareholders in the acqusition. For example, if the acquiring corporation issued 50 percent of its participating stock to the loss shareholders, then 35 percent of the post-acquisition income could be offset by the loss corporation's net operating loss carryovers.

If the acquiring corporation issued to loss shareholders only preferred stock with a "market rate" yield, the net operating loss carryovers otherwise available would be allowed only to the extent of dividends paid or accrued on the preferred stock issued in the acquisition. Special rules would be applied in cases in which the acquiring corporation had preferred stock outstanding at the time of the acquisition and to situations in which hybrid securities are issued to loss shareholders in an acquisition.

Although we believe that the merger rule might work well when only common stock or preferred stock with a determinable rate of return is outstanding after a reorganization, application of the merger rule may be unworkable in cases in which more complicated types of securities are involved. Recognizing this, the proposal, in general, contemplates that allowable net operating loss carryovers would be computed under both the purchase rule and the merger rule when convertible securities, options, warrants and the like were issued in an acquisition, and the rule providing the lower limitation would be used.

Although the merger rule may be sound in concept, we question whether it could be applied affectively to reorganizations other than relatively simple ones. In light of such narrow applicability, we question whether the additional complexity created by the existence of two sets of rules is warranted. Moreover, we are concerned that the existence of two sets of rules creates the potential for inconsistent treatment of similar transactions. For these reasons, it may be appropriate to apply the purchase rule to all acquisitions of loss corporations. We recognize that application of the purchase rule would require the difficult task of valuing stock received in a tax-free reorganization; however, such valuation would in any event be required under the reorganization rule whenever hybrid securities were outstanding.

New stock issues

The proposal provides no limitation on the use of net operating loss carryovers if new stock is issued for cash or property by a loss corporation pro rata to shareholders who owned stock during the year in which the net operating loss was incurred. Moreover, no limitation would apply if such shareholders increased their interest in the fair market value of the loss corporation's participating stock by 50 percent or less. We recognize that imposing no limitations on net operating loss carryovers in these situations may be appropriate.

If a loss corporation issued new participating stock to third parties, however, the merger rule would limit subsequent use of the net operating losses based on the percentage interest in the loss corporation's participating stock remaining with loss year shareholders. Similarly, if a loss corporation issued new preferred stock to third parties, the proposal would decrease the income that could be offset against otherwise available net operating losses by the total yield on such newly-issued preferred stock.

Although limiting subsequent use of net operating loss carryovers in cases in which contributions are made to the capital of the loss corporation is consistent with the underlying theory of the pool of capital approach, such a provision should be studied carefully prior to enactment. The proposed change would seem to encourage loss corporations to borrow capital, rather than to seek new equity capital. Such a bias in favor of debt undoubtedly would put added pressure on the tax rules provided to distinguish debt from equity. Moreover, such a rule might unduly discourage attempts to rehabilitate loss corporations, a pressure we believe should be avoided.

Investment assets

In its news release announcing the proposal, the Subcommittee invited testimony on the question whether a loss corporation which has converted operating assets to passive investment assets should be able to retain or to transfer net operating losses incurred with respect to the operating assets. So long as the rules relating to contributions to capital and new stock issues would prevent avoidance of the applicable limitations, we believe that, in theory, such a corporation generally should be able to retain and transfer its net operating loss carryovers to the same extent as a corporation that has primarily operating assets. In the context of the pool of capital approach, it is difficult to distinguish between a loss corporation that continues to own its operating assets and one that has converted those assets to passive investment assets. Moreover, it would be difficult to define the term investment assets in many industries, including banking, insurance and securities. Finally, applying special rules to corporations that convert operating assets into investment assets would have the undesirable effect of encouraging the loss corporation to retain unprofitable businesses rather than convert them into more liquid investments.

The unlimited ability to sell a corporation the assets of which include only investment assets and net operating loss carryovers, however, might be perceived as being inequitable and thus might affect the public's view of the tax system. We recognize, moreover, that the ability to convert business assets into investment assets prior to a purchase or reorganization might in some instances permit abusive transactions. Accordingly, if such corporations are allowed to transfer net operating loss carryovers, we would like to work with the Subcommittee to develop any safeguards necessary to prevent abuse of the rules.

Miscellaneous

Under the proposal, creditors who exchange debt for stock would be treated as purchasers receiving shares in a new issue. Any stock received for debt that was held by creditors of the loss corporation in the loss year would be treated as stock outstanding in that year and thus would not be subject to any limitation.

This rule reflects the fact that creditors frequently are the parties that economically bear the losses that are reflected in the net operating losses. However, the legitimate interests of these creditors must be balanced against the possibility that this rule could be used to avoid the application of the purchase rule. We will be happy to work with the Subcommittee in seeking to fashion an appropriate balancing of these interests.

The proposal also would make section 269 and the common law continuity of business enterprise doctrine inapplicable to disallow net operating loss carryovers. If effective rules are provided in the proposal to limit improper use of such carryovers, no additional limitations such as section 269 or continuity of business enterprise would be needed.

CONCLUSION

The proposal advanced by the Subcommittee represents a positive start toward resolving the problems that have arisen with respect to limitations on the utilization of net operating loss carryovers and other tax attributes following certain corporate transactions. We look forward to working with the Subcommittee in refining the proposal and in developing an effective and workable legislative solution.

This concludes my prepared remarks. I will be happy to respond to any questions.

Mr. GUARINI. I would like to call the panel of the American Bar Association, Section on Taxation, Edward N. Delaney, chairman of the taxation section, and for the New York State Bar Association, Willard B. Taylor and Herbert L. Camp, chairmen of the tax section and committee on corporations respectively.

Gentlemen, we welcome you. We appreciate your testimony and advice on this long-standing subject matter.

STATEMENT OF EDWARD N. DELANEY, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. DELANEY. Congressman, I am Edward N. Delaney, chairman of the Section of Taxation of the American Bar Association. Today I am accompanied by John Jones, our vice-chairman of government relations, and by Mike Wasserman who is the principal draftsman of our statement.

I appear today to express the views of the section regarding the treatment of net operating loss carryovers and other tax attributes by the Internal Revenue Code. Because of the short period of time between the notice and the date of these hearings, we have not been able to present this issue to the policymaking bodies of the American Bar Association. Therefore, the views I express represent only those of the Section of Taxation and should not be construed as representing that of the American Bar Association.

Again, because of the extremely short time between notice of these hearings and the hearing date, the Section of Taxation cannot fairly react with specificity to the details and implications of this subcommittee's September press release.

As you know the effective date of the 1976 amendments to section 382 have been deferred several times. Clearly, these amendments are complex, and reach arbitrary and, we believe, unreasonable results. Were they to become effective, a vast amount of time and effort would be expended by taxpayers, their advisers, and Government personnel. Effective interpretation and administration of the 1976 amendments is doomed, we believe, from the start and would be a waste of vital and limited resources. Something should be done to insure that this does not occur.

The section would not normally support a further postponement of the effective date of the 1976 amendments. However, it is our understanding that the Senate Finance Committee and its staff are currently engaged in a comprehensive study and proposed redrafting of subchapter C of the code, including section 382.

It is our understanding that the proposals outlined in the announcement of this hearing are not inconsistent with the apparent direction of that work. Consequently, we believe that a brief further extension of the effective date of the 1976 amendments, so that any legislative proposals emanating from these hearings might take account of the work product of the Senate Committee may well be in order.

The fundamental goal of attributes limitations should be neutrality. Limitations should be triggered where the economic value of beneficial tax attributes may be abnormally inflated, and those limitations should work to assure, within the limits of practicality, that those beneficial tax attributes will retain their normal value. Neutrality should be the sought after goal.

Moreover, the effect of the attribute limitation should be certain and readily calculable so that the beneficial attributes can be transferred at no appreciable discount for legal uncertainty. Owners of loss corporation should no longer be denied the value of their beneficial attributes in the bargaining process because of the buyer's inability to determine how the tax law will treat those attributes after the change in ownership.

In seeking a section 382 that is tax neutral, that is, that effectively limits post-acquisition utilization of attributes and does so by reference to a notion of what the loss company's utilization would have been had no acquisition occurred, we acknowledge a general agreement with the American Law Institute's conclusion and this subcommittee's proposal.

We recognize that it is far easier to state the principle of neutrality than it is to craft statutory language to implement neutrality. The Tax Section has long supported simplification of the Nation's tax laws. We see few areas in which simplification is more needed than in the attribute limitation area.

Both the American Law Institute's and your proposal apply two separate income approaches to govern how much of the acquiring taxpayer's income can be offset by the acquired taxpayer's losses and when. These variable limitations depend upon the type of acquisition transaction involved and the consideration used in the transaction.

We wonder if the ultimate solution to be proposed cannot accomplish the goal sought while involving a single limitation applicable whenever a limitation is appropriate, without regard to the type of acquisitive transaction involved, or the type of consideration given in the acquisitive transaction. We urge the subcommittee to give further study to this aspect of the proposal.

Your September 8 announcement also invites specific comment on the investment asset question—whether special limitations should apply in the case of a loss corporation that has converted former operating assets to passive investment assets. Logically, to the extent that attribute limitations are intended to be tax neutral, no special limitations should apply.

Passive investment assets like operating assets can be expected to produce income against which beneficial attributes could be utilized by the loss corporation without any change in ownership. If a corporation that changes or terminates its business, but not its owners, may utilize its attributes against its future income, the principle of neutrality dictates that those attributes be available to a corporation that changes both its business and its ownership. The tax laws should present neither an incentive nor a disincentive to the changing of the ownership of corporations.

It may be that special policy considerations support a deviation from the principle of neutrality for situations involving loss corporation that have converted former operating assets to passive investment assets. Even if such considerations exist, they may not be so substantial as to justify the increase in complexity that special limitations would no doubt introduce.

With that, we will conclude our statement and we will answer any questions you might have at the appropriate time.

[The prepared statement follows:]

STATEMENT OF EDWARD N. DELANEY, CHAIRMAN, SECTION OF TAXATION ON BEHALF OF THE AMERICAN BAR ASSOCIATION

SUMMARY

I. A brief additional extension of the effective date of the 1976 amendments to section 382 should be considered.

II. A limitation on tax attributes is appropriate, but must be crafted so as to be tax neutral.

III. Further study may well develop a proposal that accomplishes the goal of enacting a tax neutral limitation that is less complex than those currently under consideration.

IV. No special limitations are warranted in situations where a loss corporation has converted former operating assets to passive investment assets.

STATEMENT

I am Edward N. Delaney, Chairman of the Section of Taxation of the American Bar Association. I appear today to express the views of the Section regarding the treatment of net operating loss carryovers and other tax attributes by the Internal Revenue Code (hereafter "Code"). Because of the short time between notice and the date of the hearings, we have not been able to present this issue to the policymaking bodies of the American Bar Association. Therefore, the views I express represent only those of the Section of Taxation, and should not be construed as representing the Association.

Again, because of the extremely short time between the notice of these hearings and the hearing date, the Section of Taxation cannot fairly react with specificity to the details and implications of this Subcommittee's September 8 press release, which I will refer to as the "proposal."

As you know, the effective date of the amendments to section 382 have been deferred several times. Currently, they are scheduled to become effective January 1, 1984. Clearly, those amendments are complex, and reach arbitrary and irrational results. Were they to become effective, a vast amount of time and effort would be expended by taxpayers, their advisors, and government personnel to deal with intricate rules. Effective interpretation and administration of the 1976 amendments is doomed from the start, and would be a waste of vital and limited resources. Something should be done to insure that this does not occur.

The Section of Taxation would not normally support a further postponement of the effective date of the 1976 amendments. However, it is our understanding that the Senate Finance Committee and its staff are currently engaged in a comprehensive study and proposed redrafting of Subchapter C of the Code, including section 382. It is our understanding that the proposals outlined in the announcement of this hearing are not inconsistent with the apparent direction of that work. Consequently, we believe that a brief further extension of the effective date of the 1976 amenments, so that any legislative proposal emanating from these hearings might take account of the work product of the Senate Committee proposal, may be in order.

Since the Senate proposal may not proceed as rapidly, or ultimately, in the same dirction as this Subcommittee's proposal, it is quite appropriate for this Subcommittee and the Section to address section 382 modification at this time, even though we have suggested a further extension of the effective date of the 1976 amendments. Our consideration is made easier by virtue of the fact that your proposal is similar to the suggestions of the American Law Institute, which were adopted after extensive study by that organization.

The fundamental goal of attributes limitation should be neutrality. Limitations should be triggered where the economic value of beneficial tax attributes may be abnormally inflated, and those limitations should work to assure, within the limits of practicality, that those beneficial tax attributes will retain their normal value. To repeat, the limitations should prevent an abnormal increase in the value of an attribute, but not produce an abnormal decrease in that value. Neutrality should be the sought-after goal.

Moreover, the effect of the attribute limitations should be certain and readily calculable, so that the beneficial attributes can be transferred at no appreciable discount for legal uncertainty. Owners of loss corporations should no longer be denied the value of their beneficial attributes in the bargaining process because of the buyer's inability to determine how the tax law will treat those attributes after the change in ownership.

As a specific example of how neutrality should work, consider T, a relatively small corporation with existing net operating losses of $1,000,000. Assume that under normal circumstances, T could be expected to generate taxable income before any net operating loss deduction of $50,000 annually. In the absence of extraordinary circumstances, T would offset $50,000 of its existing net operating losses against its otherwise taxable income each year for up to 15 years. Some losses, $250,000, in the example, would expire unused.

Instead, suppose T is merged into relatively large corporation P, and the combined entity, PT, generates $250,000 of current taxable income annually. In the absence of limitations, PT would use T's past net operating losses at the rate of $250,000 annually, exhausting the entire $1,000,000 of loss carryovers in four years. No portion of the net operating losses would expire unused.

We suggest that the increased utilization of T's net operating losses from $750,000 to $1,000,000 and the use of those losses in a four tax-year period, as distinguished from a fifteen tax-year period, may exemplify an abnormal inflation in the value of the net operating loss attribute. The inflation in value results from PT's ability to use more of the attribute than T could have used, and to use more of the attribute at an earlier date.

In these circumstances, it might well be argued that the net operating loss limitations should apply to limit PT's net operating loss deductions to the $50,000 annual income that T alone would have enjoyed.

In seeking a section 382 that is tax neutral, that is, that effectively limits post-acquisition utilization of attributes and does so by reference to a notion of what the loss company's utilization would have been had no acquisition occurred, we acknowledge a general agreement with the American Law Institute's conclusions and this Subcommittee's proposal.

We recognize that it is far easier to state the principle of neutrality than it is to craft statutory language to implement neutrality. The Tax Section has long supported simplification of the nation's tax laws. We see few areas in which simplification is more needed than in the attribute limitation area. While we have no magic formula to propose, we would expect that as these hearings progress, ideas may emerge that go further than your proposal in achieving simplification without sacrificing the neutrality goal of the attribute limitation principle.

Both the American Law Institute solution, and your proposal, apply two separate income limitation approaches to govern how much of acquiring taxpayer's income can be offset by the acquired taxpayer's losses, and when. These variable limitations depend upon the type of acquisition transaction involved, and the consideration used in the transaction. Thus, in some cases, the limitation would be measured by reference to the continuing proportionate ownership of the loss company's shareholders in the combined company, while, in other cases, the limitation would be measured by reference to a hypothetical income determined as a return on the purchase price of the stock which has changed hands. Some transactions would involve a combination of the two limitations, and, in some cases, different limitations, stemming from two or more different transactions, might be applicable.

We wonder if the ultimate solution to be proposed cannot accomplish the goal sought while involving a single limitation, applicable whenever a limitation is appropriate, without regard to the type of acquisitive transaction involved or the type of consideration given in the acquisitive transaction. As between the two limitations in the current proposal—the hypothetical income return on purchase price and the continuing proportional ownership rule—we believe that the hypothetical income return on the purchase price will have greater general application, and is more likely to be invoked in a single limitation solution, rather than the limitation looking to continued proportional ownership. We urge this Subcommittee to give further study to this aspect of the proposal.

Your September 8 announcement invites specific comment on the "investment assets question"—whether special limitations should apply in the case of a loss corporation that has converted former operating assets to passive investment assets. Logically, to the extent that attribute limitations are intended to be tax neutral, no special limitations should apply. Passive investment assets, like operating assets, can be expected to produce income, against which beneficial attributes could be utilized by the loss corporation without any change in its ownership. If a corporation that changes or terminates its business, but not its owners, may utilize its attributes against its future income, the principle of neutrality dictates that those attributes be available to a corporation that changes both its business and its owership. The beneficial attributes should be neither enhanced nor diminished by a sale of T assets or stock to P. The tax laws should be present neither an incentive nor a disincentive to the changing of the ownership of corporations.

It may be that special policy considerations support a deviation from the principle of neutrality for situations involving loss corporations that have converted former operating assets to passive investment assets. Even if such considerations exist, they may not be so substantial as to justify the increase in complexity that special limitations would no doubt introduce.

We restate our agreement with the fundamental principles espoused by both the American Law Institute and the proposal—that is, that limitations on net operating losses, like other attribute limitations, should be tax neutral. We would be pleased to work with the Subcommittee and its staff in achieving that end.

Thank you.

STATEMENT OF HERBERT L. CAMP, COCHAIRMAN, COMMITTEE ON CORPORATIONS, NEW YORK STATE BAR ASSOCIATION, ACCOMPANIED BY WILLARD B. TAYLOR, CHAIRMAN, TAX SECTION

Mr. CAMP. Good afternoon.

My name is Herbert L. Camp. I am cochairman of the Committee on Corporations of the New York State Bar Association, Tax Section. I appear here on behalf of the Tax Section. With me is Willard Taylor, chairman of the Tax Section.

We make here only general comments on tax attribute carryover proposal before you. We hope and expect that if legislation is proposed, we will have the opportunity to submit detailed comments. Our written statement has been submitted, and we refer you to it.

The Tax Section believes that Congress should allow itself sufficient time to deal comprehensively and completely with the issue of tax attribute carryovers. We do not believe that appropriate legislation can be in place by January 1, 1984, when, absent further extensions, section 382 as amended in 1976 will come into effect. We, therefore, suggest that the January 1, 1984, date be further extended for up to 1 year with the view that new legislation be adopted by this Congress.

The Tax Section believes that section 382 as currently in effect is not effective to police perceived problems of trafficking in corporate tax attributes. The tax section believes further that the other principal statutory provision which is applicable in this area, section 269, is largely ineffective, sometimes penalizing transactions which should not be reached, and other times leaving effective transactions which should be reached.

New section 382, the 1976 version, is not scheduled to go into effect in 1984. The Tax Section believes that the new section 382 is inordinately complex, and is not an improvement over existing law and should not come into effect.

The central thesis of the proposal before you is that tax attributes should be allowed only against earnings from the pool of capital which created them. Under that approach, restrictions on the use of attributes would be expressed as limitations on the amount of postacquisition income or tax available for use against the attribute, not on the amount of the attribute available. We agree with that approach as being far better than current or new section 382.

Thus, as set forth in the proposal under the merger rule, where a corporation's assets are acquired for stock, its attributes should be available for use against the combined postacquisition income or tax of the acquiring corporation attributable to such stock. Attribute survival should, as the proposal contemplates, be limited to a lesser percentage than the stock percentage of the loss corporation's shareholders, thus giving effect to the issuance of stock for the tax attributes themselves.

The second basic element of the proposal is the purchase rule, under which attributes would be limited in a purchase of stock to a certain interest-like, or after-tax equity return-like, yield on the purchase price.

We believe that the purchase rule, depending as it does on the selection of a yield rate, is a less desirable rule than the merger rule, and that in cases where either rule might apply, the merger rule should govern. Thus, in a purchase for common stock not in a reorganization, the merger rule should apply, and where stock and other considerations are used, the merger rule should apply at least to the stock. Also, in a purchase for cash where the acquiring corporation's common stock is traded or otherwise subject to ready valuation, the merger rule could apply by treating the acquiring corporation as first issuing stock rather than other consideration.

As an alternative to the merger rule and the purchase rule, we suggest that the subcommittee carefully consider the possibility of a single limitation measured by the purchase price for the loss corporation itself. Adoption of such a single rule for all transactions would avoid complexity and the necessity of selecting a rate of return.

To guard against diversion of income opportunities to an acquiring corporation, thus permitting accelerated earnout of the losses, a rule limiting the losses to the purchase price or a fraction thereof could be accompanied by a rule requiring that the losses be utilized no sooner than, say, at rate of 20 percent per year following the acquisition.

Our other recommendations are that section 269 be repealed outright as a limitation on attribute carryovers; that acquisitions by loss corporations of profitable corporations for stock be treated the same as acquisitions by profitable corporations of loss corporations for stock; that the merger rule provide for allocation of postacquisition taxable income after reduction by dividends on outstanding preferred stock not issued in the acquisition, and that the purchase rule permit some non pro rata increases in stock held by historic shareholders.

The subcommittee asked whether there ought to be special rules to restrict the survival of attributes where an operating business is sold and the proceeds invested in passive assets. We see no good reason for special restrictions in that case. The distinction between an active business which produced or the sale of which generated a loss, and a passive replacement business which may produce income to earn out the loss does not justify restricting the use of attributes. Any restriction would be contrary to the underlying partnership or pool of capital theory, and a return to the change-of-business concepts of present section 382(a).

We would appreciate the opportunity to comment on any proposed legislation or otherwise be helpful to you in connection with this important project.

Thank you very much.

[The prepared statement of follows:]

STATEMENT OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION

CARRYOVER OF CORPORATE TAX ATTRIBUTES

My name is Herbert L. Camp. I am co-chairman of the Committee on Corporations of the New York State Bar Association Tax Section and appear here on behalf of the Tax Section. With me is Willard B. Taylor, Chairman of the Tax Section.

The Tax Section has over 2,800 members, all of whom are lawyers with a professional interest in taxation. They include practicing lawyers, judges, professors of law, corporate counsel, and officials and employees of the Treasury Department and the Internal Revenue Service.

This statement of the Tax Section sets forth its views on the proposal for the carryover of tax attributes described in Press Release #8, dated September 8, 1983, issued by the Subcommittee on Select Revenue Measures, Committee on Ways and Means.

The Tax Section appreciates the opportunity to comment on the proposal. Several members of the Section have participated over the past months in a continuing project with staff of various congressional committees, and Treasury Department and Internal Revenue Service officials, to examine possible changes in Subchapter C of the Internal Revenue Code, including the provisions dealings with carryovers. The proposal before the Subcommittee is similar in many respects to the treatment of carryovers under consideration in that project.

We make here only general comments on the proposal, which, not being in legislative form, is itself also general. We hope and expect that, if legislation is proposed, we shall have the opportunity to submit detailed comments.

The Tax Section believes that Congress should allow itself sufficient time to deal comprehensively and completely with the issue of tax attribute carryovers. We do not believe that appropriate legislation can be in place by January 1, 1984, when, absent further extension, section 382 as amended in 1976 will come into effect. We therefore suggest that the January 1 effective date be further extended for up to one year, with the view that new legislation be adopted by this Congress.

We make no comment herein on the bankruptcy and debt cancellation aspects of the proposal. The Tax Section expects to submit written comments on those aspects later.

The Tax Section believes that section 382 as currently in effect (i.e., without giving effect to the 1976 amendments) is not an effective method to police perceived problems of trafficking in loss carryovers and other corporate tax attributes. The Tax Section believes, further, that the other principal statutory provision which is applicable in the area, section 269, is largely ineffective, sometimes penalizing transactions which should not be reached and leaving unaffected transactions which should be reached.

"New" section 382, i.e., as amended in 1976, is now scheduled to go into effect in 1984. The Tax Section previously issued a Report on section 382 as amended.[1] That Report concluded that it was doubtful that the complexity added by the amendment to section 382 was worthwhile (p. 284), suggested that loss carryovers might well be made freely transferable (p. 286), argued that a mere change of ownership of a corporation should not restrict the use of tax attributes (p. 287), and recommended further amendments to harmonize sections 382 (a) and (b) (p. 299).

The proposal described in the Press Release addresses in a helpful fashion all those points but free transferability, and we assume that portability or transferability is not now under consideration by this Committee.

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[1] New York State Bar Association Tax Section, "Report on section 382 of the Internal Revenue Code as amended by the Tax Reform Act of 1976," 31 Tax Law. 283 (1978).

The central thesis of the proposal—in turn based on the American Law Institute ("ALI") proposals—is that loss carryovers and other tax attributes should be allowed only against earnings from the "pool of capital" which created them. Under that approach, restrictions on the use of attributes would be expressed as limitations on the amount of post-acquisition income or tax available for use against the attribute, not the amount of the attribute available. We agree with that approach, subject of course to review of its actual form in proposed legislation.

Thus, as set forth in the proposal under "The Merger Rule," where a corporation's assets are acquired for stock, its attributes should be available for use against the combined post-acquisition income or tax of the acquiring corporation attributable to such stock. Attribute survival should (as the proposal contemplates) be limited to a lesser percentage than the stock percentage of the loss corporation's shareholders, thus giving effect to the issuance of stock for the tax attributes themselves.[2] Implementation of that rule would eliminate any incentive to acquire corporations with no assets other than carryovers and, by and large, would eliminate any incentive to pay for tax attributes of a corporation that had real operations.

The manner of application of the proposal's Merger Rule to an acquisition of a subsidiary in a reorganization is not clear. Thus, if P acquires T in a "B" reorganization for 50 percent of P's stock, are the loss carryovers of T useable only at the rate of 35 percent of T's separate income? Or is the 35 percent to be applied to the P-T combined income? Or the lesser of 35 percent of the P-T combined income and 100 percent of T's separate income? Or is a rule like that in present section 382(b)(6) to apply, so that 100 percent of T's income can be used? If there is concern that, as in the purchase situation, "income opportunities" will be diverted to T, the combined income approach might be best. We assume that, as under the ALI proposals, the combined income approach (not further limited to T's income) is intended.

The Merger Rule contemplates that where there is a reorganization for preferred stock, the dividend yield on the stock would measure the limitation. However, in a transaction in which both common and preferred stock are used, the above preferred stock rule should apply, but the common stock proration rule should as well apply to earnings in excess of the preferred stock dividend.[3]

The second basic element of the proposal is the Purchase Rule, under which attributes would be limited in a purchase of stock to a certain interest-like (or after-tax equity return-like) yield on the purchase price. We believe that the Purchase Rule, depending as it does on the selection of a yield rate, is a less desirable rule than the Merger Rule, and that in cases where either rule might apply, the Merger Rule should govern. Thus, in a purchase for common stock not in a reorganization, the Merger Rule should apply, and where stock and other consideration are used, the Merger Rule should apply at least to the stock.[4] Also, in a purchase for cash where the acquiring corporation's common stock is traded or otherwise subject to ready valuation, the Merger Rule should apply by treating the acquiring corporation as issuing stock rather than other consideration. For example, if one corporation acquired another as a subsidiary for $10 million cash, the proposal (using a 10 percent after-tax rate) would allow the use of the acquired corporation's loss carryforwards at the rate of $1 million per year. If the acquiring corporation were a publicly-traded corporation having 3,000,000 shares outstanding traded at $10 per share, the acquired corporation could be treated as acquired for 1 million shares, and the Merger Rule could then apply. Assuming that the Merger Rule would be applied on a combined income basis (see above), 13.75 percent of the combined earnings would be available against the loss carryforward.

As an alternative to the Merger Rule and the Purchase Rule we suggest that the Committee carefully consider the possibility of a single limitation measured by the purchase price for the loss corporation itself. Under such an approach, it would be impossible for an acquiring corporation to profit from the purchase of tax losses, since the tax benefit from the tax loss is always a lesser amount (46 percent under current tax rates) than the loss itself. Adoption of such a single rule for all transactions would avoid complexity and the necessity of selecting a rate of return. To guard against diversion of income opportunities to an acquired corporation, thus permitting accelerated earnout of the losses, a rule limiting the losses to the purchase price could be accompanied by a rule requiring that the losses be utilized no sooner than, say, at a rate of 20 percent per year following the acquisition. In that event, it might be possible to limit the losses to an amount slightly in excess of the purchase price, to make up for that deferral.

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[2] Thus, as in the proposal, if the shareholders of the loss corporation received 50 percent of the common stock of the combined company, only 35 percent of the combined income would be available to be offset by loss carryforwards. For purposes of illustration herein, we assume that if the loss corporation's shareholders receive 25 percent of the common stock, the relevant percentage is 13.75 percent; and if they receive 40 percent, the relevant percentage is 25 percent.

[3] For instance, if P acquired T by merger for $1 million of 10 percent perferred stock and common stock representing 25 percent of P after the merger, and P had earnings of $5 million after the merger, T's losses should be useable at a rate of $773,750 per year ($100,000 in respect of the preferred stock and $673,750 in respect of the common stock).

[4] For instance, if P acquired T as a subsidiary for $1 million of cash, and common stock representing 40 percent of P after the merger, and P-T had earnings of $5 million after the merger, then, assuming a 10 percent rate of return, T's losses should be useable at a rate of up to $1,325,000 per year ($100,000 in respect of the cash and $1,225,000 in respect of the common stock).

Our other recommendations are as follows:

(1) *Section 269.*—Section 269 should be repealed outright as a limitation on attribute carryovers. It may be necessary, of course, to have provisions in the new legislation to authorize anti-abuse regulations.

(2) *Acquisition by loss corporations.*—Acquisitions by loss corporations of profitable corporations for stock should be treated the same as acquisitions by profitable corporations of loss corporations for stock. Present law favors the acquisitions of profitable corporations by loss corporations.

(3) *Preexisting preferred stock.*—The Merger Rule should provide for allocation of post-acquisition taxable income after reduction by dividends on outstanding preferred stock not issued in the acquisition. For example, if P acquired T by merger for $1 million of 10 percent preferred stock and common stock representing 25 percent of P after the merger, and P had $5 million of 10 percent preferred stock previously outstanding and earnings of $5 million after the merger, T's losses should be useable at a rate of $705,000 per year ($100,000 in respect of the preferred stock issued in the merger and $605,000 in respect of the common stock).

(4) *New preferred stock.*—The proposal limits the use of loss carryovers of a target corporation acquired for preferred stock to the dividends thereon, but it would seem that there should be a further reduction in the use of the tax attributes to take account of the issuance of stock for the tax attributes.

(5) *New issuances.*—We suggest that the rules permit some non-pro rata increases in stock held by historic shareholders. Thus, if A and B each own 50 percent of L, a loss corporation, the proposal would allow pro rata (as well as de minimis) increases in L's equity, but non-pro rata increases (beyond the de minimis) would bring the Merger Rule into play. We think that some increase (such as 50 percent) in relative percentage stock ownership, by value, should be permitted.

(6) *Passive assets.*—The Subcommittee asked whether there ought to be special rules to restrict the survival of attributes where an operating business is sold and the proceeds invested in passive assets. We see no good reason for special restrictions in that case. The distinction between an "active" business which produced (or the sale of which generated) a loss and a "passive" replacement business which may produce income to earn out the loss does not justify restricting the use of attributes; and any restriction would be contrary to the underlying "partnership" or "pool-of-capital" theory, and a return to the change-of-business concepts of present section 382(a).

(7) *Built-in loss.*—Rules similar to the present consolidation return limitations on built-in deductions (*i.e.*, if such losses are material, they should be limited just as are carryovers) should apply generally. Consideration should be given to offsetting built-in losses by built-in gains.

(8) *Other considerations.*—We have not attempted to comment comprehensively in the area of tax attribute carryovers and there may be other situations than those mentioned above which deserve special treatment. For instance, consideration could be given to an exception for stock issuances to employees and to an exception in stock purchases where the purchase is by one shareholder of stock of another, such as pursuant to a buy-sell arrangement.

We would appreciate the opportunity to comment on any proposed legislation and otherwise to be helpful in connection with this important project.

Mr. GUARINI. Mr. Taylor, chairman of the Tax Section.

Mr. TAYLOR. I have nothing further on it. This is our statement.

Mr. GUARINI. Fine.

As I understand, everybody feels that there should be an extension of the effective date of the statute because of the complexity, the care, and attention that it requires, more time and more thought. Is that a fair statement of the testimony?

Mr. DELANEY. That is true. We don't know if it has to be a year or some shorter period of time. We believe that amendment of section 382 ought to be accomplished in this Congress.

Mr. GUARINI. On the purchase rule that the Treasury talked about, concerning the 51 to 99 percent rule, do you agree with the differential of 50 percent and 100 percent that they talked about?

Mr. TAYLOR. Do you mean on the use of the purchase rule instead of the merger rule?

Mr. GUARINI. Yes.

Mr. TAYLOR. I think we prefer the merger rule. The purchase rule implies that you know what the right rate of return is. It also implies, I think, that all operating losses can be used by the acquiring corporation. Our preference is for the merger rule, to the extent you can use it, because it does not rest on a fixed rate of return, and it does not assume, which may be contrary to the facts of the particular case, that the loss is good forever. So we would take the merger rule and push it as far as we can.

Mr. GUARINI. Should there be any bias between purchases and mergers?

Mr. Taylor. No, and that of course is the problem. If at some point you have to apply the purchase rule, you have to make assumptions as to the rate of return and the useability of the loss carryover, and then you create a differential between the merger rule and the purchase rule. The only persuasive justification for going to a single purchase rule is that you find this to be an intractable problem, one so difficult that you decide that simplicity is more important than having the merger rule.

Mr. GUARINI. So there would be no favoritism or differential that would exist, in other words.

Mr. TAYLOR. You would try to design it so that there would be none, yes sir.

Mr. DELANEY. Mr. Wasserman would like to comment.

Mr. WASSERMAN. I would like to echo the sentiments expressed on simplicity. There are a number of different limitations, different types of limitations being tossed about, but I am hearing and I agree with a sense that it would be best, if at all possible, to try and come up with one kind of limitation that will govern in all situations.

I think you were speaking of a situation where there would be, perhaps, some combination, some stock, and some cash, or only part of the stock is acquired in the purchase transaction. I suspect that trying to apply the two limitations to that transaction, particularly if it is followed by additional transactions, will quickly degenerate into a nightmare of analysis that the vast majority of taxpayers, tax advisors, tax examiners would not be able to handle and, therefore, will not try to examine.

Mr. GUARINI. Should passive and active income be treated the same way? I think philosophically we treated it differently on personal income taxes until 2 years ago.

Mr. TAYLOR. We would treat it the same way.

Mr. GUARINI. The same loss.

Mr. DELANEY. If you were to find particular situations that might really be deemed to be abusive, there might have to be some additional limitation, but you really should consider how great the revenue implication of that is before you add to the complexity.

Mr. GUARINI. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Stark had an opening statement, which was read by Mr. Flippo, and in one section he says: "Unless we do something to reduce trafficking in these carryovers, we will be faced with a tremendous growth in merger activity." Would you care to comment on this, sir?

Mr. WASSERMAN. I would.

Mr. DUNCAN. Would you identify yourself, sir?

Mr. WASSERMAN. I am Michael Wasserman, and I am with the ABA Tax Section.

The principle of neutrality should assure that Treasury neither gains nor loses as a result of any acquisition be it by way of taxfree or taxable acquisition. A corollary of that, and I think you can work out the mathematics of it, would be that no one would be paying more money than would be an appropriate price for corporations which happen to have tax attributes, so that there should be no incentive toward mergers and acquisitions. There is not going to be a bargain element there.

Mr. DUNCAN. Do you think that there is an incentive now?

Mr. WASSERMAN. I think that under the present section 382 there is. It is too easy to plan around section 382 and preserve all of the attributes.

Mr. DUNCAN. Is there a great deal of trafficking going on in the sale of the carryovers?

Mr. WASSERMAN. In my experience less than you might think. It is talked about tremendously, and much more rarely done in my experience, and I can't speak for everybody else.

Mr. DORGAN. Would the gentleman yield?

Mr. DUNCAN. I will be happy to yield.

Mr. GUARINI. I am inclined to agree with you. Why is that so? Do you think that there is a sense that in fact it won't fly, and people are too cautious, and Treasury would frown upon it and examine it further?

Mr. WASSERMAN. I think that is a large part of it. There is section 269, and people do worry about that. They are often willing to take a chance on that, at least they speak about being willing to take a chance on that, but they will try very hard to convince themselves, as well as anyone else who is interested, that there are real substantial business purposes to an acquisition.

If trafficking means acquiring someone that you are interested only in the tax attributes for, I think there is a lot more talk about that than action. To the extent that there is a political problem that is perceived as being something that is very active, you have to deal with that. To the extent that that problem has been enhanced by the safe-harbor leasing that is an unfortunate fact of life.

Mr. DUNCAN. Some companies that is all they have, the tax loss, isn't it?

Mr. WASSERMAN. There are a few. They are not bought and sold.

Mr. DUNCAN. That is what we see advertised always, the tax loss carryover.

Mr. DELANEY. I think there may be more talk about them, Mr. Duncan, than transactions undertaken.

Mr. DUNCAN. Most things there is more talk about than do. [Laughter.]

He also says: "If a corporation can utilize its tax department as a profit center, why should it bother to attempt the difficult task of battling foreign competitors?"

Are you aware of corporations that have been using their tax department as a profit center? Mr. Wasserman, you might like to comment on that.

Mr. DELANEY. I would certainly hope that the tax department would be aware of the tax implications of transactions in advising. I don't know whether you would call that a profit center. I really don't think that good tax planning is inconsistent with also good business judgment, and competing with your competitors. The tax is not yet 100 percent.

Mr. GUARINI. It is a profit center for the CPA, though.

Mr. DELANEY. I wish you would have said lawyers, also, Mr. Guarini, knowing your background.

Mr. DORGAN. Would you yield on that question, Mr. Duncan?

Mr. DUNCAN. Yes; I will be glad to.

Mr. DORGAN. My judgment is that it is done all the time and far too often. Having worked in the tax field for some 10 years, in the field of State taxation and multinational income, it was clear to me from auditing, looking at the books and records, as our auditors did, of many corporations that did business in more than one State, that they can make a great deal of money by playing shell games with the tax code.

Rather than go out and sell $15 or $20 worth of goods, if you can find $1 worth of tax benefits at the bottom of the P&L statement, you can save yourself a lot of time. I think that it is done all the time. I think it has become a big industry. My judgment is that it saps our economic strength, and I think that is why we are having the hearing.

Mr. DELANEY. Mr. Dorgan, I hope that the tax department employees are doing the best job they can, but I don't necessarily accept your designation of shell games. Intercompany pricing is a problem, there is no question, but there are ways of looking—I know you and I have discussed things like this before. I know of your concern, and I think we all ought to be concerned about shell games.

Mr. DUNCAN. Mr. Chairman, let me yield the balance of my time to Mr. Dorgan to explore that question.

Mr. DORGAN. I appreciate that. Thank you.

The point I was trying to make is that I have, for example, won a State court case against a multinational corporation in which the State court required that the corporation disclose all of the State tax returns that they had filed in every State in which they did business.

I happen to know personally from looking at those returns that that corporation played a shell game, telling one State we did this business in this State, and we earned this income there, and telling the other State exactly the opposite thing, protecting a substantial amount of their net income from any State taxation whatsoever. I happen to know also from a lot of auditing that the auditors that I employed did that. That is not unusual.

I guess the point I was trying to make to the question that Mr. Duncan asked, and I think directly on the point that the chairman made in his statement, in my judgment, is, yes, indeed, we have a blizzard of paper between CPA's and attorneys in this country that produces nothing, that yields nothing, weakens America, and I think it saps the strength of a lot of corporations.

We are better off closing that portion of the law that allows people to put on green eyeshades and sap their energy doing this, and get them back to building better cars, selling abroad, and so on. The corporations, I know, snicker and say, well, this isn't going on. The hell it isn't going on. It is going on all the time. I just wanted to make that point.

Mr. TAYLOR. I think we all agree that there is a serious problem. The proposals that have been discussed here, either the merger rule or the purchase rule, would basically eliminate trafficking. There is no doubt about it.

To the extent that we have said to you take some more time to consider this project, it is not because we don't regard it as serious or because we don't agree that you should have rules that put an end to trafficking. It is a feeling that what is done ought to be done with deliberation. This is an area in which we have had a number of false starts. Nobody is happy with present law and nobody is happy with what was done in 1976. It ought to be a considered response.

Mr. GUARINI. I think we all share the same concerns in our philosophies. What we are talking about is perception. My coming from so near to New York, I can't go to lunch without having someone say I have a corporation that has a big tax loss and we can use it. For every one that is discussed that way, there are very few that really follow through on it. I know people have many corporations that have huge tax losses that they put into their drawer, and they intend to use them some day, and they never use as many as they seem to have because there is an awful lot of them out there.

I can understand, perhaps, coming from another part of the country, that you would be greeted with fewer situations than you in your daily conversations if you are only a mile from Wall Street.

The concern is real and I do share the concerns of the Bar Association—and Treasury feels the same way. It is interesting, when you have a country this big, you can come from different directions and get different values in your perceptions.

I want to ask a question for the record. Do the personal holding company rules, or accumulated earnings tax rules, as a practical matter, limit the ability of a loss corporation to use up its net operating losses by acquiring assets? If so, why should assets be treated the same as business assets under the proposal?

I know we have discussed it, but I just want, for the record, some point to be made concerning accumulated earnings tax rules and the personal holding companies.

Mr. TAYLOR. Those are rules of rather limited applicability. The personal holding company tax is limited to closely held corporations with substantial or nothing but passive assets. The accumulated earnings tax is also a rule of very limited applicability. I don't think they really have any bearing on net operating loss carryovers.

Mr. Delaney. I would agree with that, Mr. Guarini.

Mr. Guarini. I just wanted to ask for the record.

Mr. Duncan, anything further?

Mr. Duncan. No, Mr. Chairman.

Mr. Guarini. Mr. Dorgan.

Mr. Dorgan. You are not suggesting that the values are different in New York than in North Dakota? [Laughter.]

Mr. Guarini. Not the human values.

Mr. Dorgan. Having tarred the rule with a black brush, let me hasten to point out that I think there is a lot of good in our industrial sector, the shrewd Yankee traders that have made this country strong, and the entrepreneurs that made the products that have helped to make us strong, I think, can prevail in the future, but not if we continue the paper blizzard that we have steadily been chasing in the last few years.

I am very concerned about mergers. I am very concerned about tightening the laws with respect to the NOL, and so on. I am also concerned about the 1976 amendment, and the fact that rules have not been developed—we are talking 7 years here. At some point we have got to make some decisions to do something about it. The easiest thing in Washington is to do nothing, I understand that.

The reason that I wasn't present during the first part of the hearing is that we have a technical issue on insurance tax that we are dealing with, and it is turning out to be hundreds and hundreds of hours for all of us. That is the reason I wasn't here for the first part of the hearing, but I intend to read your statements.

I just wanted to point out, having the opportunity here, that I am very interested in this issue. We have got to do some things together in the interest of American corporations, and also in the interest of Government, to try and tighten this up and see if we can't go forward building good products again, and making this whole thing work without shifting paper around.

Mr. Delaney. Mr. Dorgan, the 1976 amendments were really not the result of any great study or thought at the time. They were kind of snapped in at the last minute.

Mr. Dorgan. I understand that.

Mr. Wasserman. Until today, or until there is a change in the law, I think it is fair to say that the policies behind section 382 are mixed and have never been very well articulated. The word "trafficking" is used, and if you ask 100 people, you will get at least 50 different definitions of what is trafficking.

I think you are hearing today the consensus that the guiding principle in this area should be neutrality. There would finally be a single policy that would govern this area, that would enable a fairly simple statute to be written, that would enable a court to interpret knowing what it is trying to do, instead of trying to reconcile judicial opinions of 30, 40, or 50 years ago.

If you are asking for progress, intellectual and political policymaking progress in the area, I don't think you will find many examples that will illustrate that kind of progress better than what the ALI has done, and the way that ball is being carried forward, and what you hear today.

Mr. **Guarini**. I think the point is well taken by Mr. Dorgan that some of our finest minds, business minds, captains of industry, perhaps spend too much time shuffling papers, trying to find how we can merge and how we can acquire, purchase, or consolidate companies, making money that way instead of by producing better quality products and adding to our Nation's productivity.

I think that the right kind of law would be a step in that direction, to increasing the productivity and making less money just by the paper routine.

I thank you very much, Mr. Delaney, Mr. Jones, Mr. Wasserman, Mr. Camp, and Mr. Taylor.

Our next panel is composed of Mr. Nicholas A. Tomasulo, Esq., of Washington, D.C., Mr. Richard L. Bacon, Esq., of Washington, D.C., and Mr. John F. Ellingson, Esq., of Seattle, Wash.

Mr. Tomasulo, Mr. Bacon, and Mr. Ellingson, we welcome you. Mr. Tomasulo, why don't we start with your presentation.

STATEMENT OF NICHOLAS A. TOMASULO, ESQ., SILVERSTEIN & MULLENS, WASHINGTON, D.C.

Mr. **Tomasulo**. I was legislation counsel to the staff of the Joint Committee from 1959 to 1973, so it is a great pleasure to come to you as a witness and say a few words.

Mr. **Guarini**. We welcome you.

Mr. **Tomasulo**. I was also the joint author with Mr. Bacon on my right of an article that just appeared in "Tax Notes" on September 12, which is attached to Mr. Bacon's statement. It describes our suggestions in fairly great detail, so I will not repeat them. It will be in the record.

What we plan to do is, Mr. Bacon will discuss the use of the capital limitation, rather than an income limitation, a purchase price rule, and also the desirability of having a single rule for both purchases and reorganizations. I will confine my remarks to just one issue, the issue as to passive investments. To my mind, all the speakers up until now have not really faced this issue or explained why investments should be deducted or should not be deducted.

I would like to begin at the very beginning. The Treasury said that the carryover losses is a method of averaging the income of a taxpayer who has good years and bad years, but does not this mean that you must average the good years and the bad years of the same taxpayer, not averaging the bad years of one taxpayer with the good years of another.

Now as a very, very simple example, as everybody in this room knows, if a woman who is single has an operating loss, and then she marries, her operating loss can never be used against her husband's income.

Mr. **Guarini**. We would have a lot of interesting marriages.

Mr. **Tomasulo**. Yes, you would.

Mr. **Guarini**. We would go around finding out who has any losses. [Laughter.]

Mr. **Tomasulo**. Let's take the simplest case, which you might call the horror case. A family owns a corporation which has a brewery.

The brewery loses money. They sell all the brewery assets and buy 10,000 shares of United States Steel. Now they sell the corporation, they sell all the stock of the corporation, to another family which intends to put in, let us say, a construction business.

Now, in what sense are those two corporations the same corporation? It seems quite clear that the corporation owned by the purchaser is really very similar to a Zombie that uses the dead body of another, that is, it uses the charter of another corporation with which it has no reasonable connection whatever.

Neither can you say that there is a reasonable connection because the corporation owned 10,000 shares of United States Steel, or $10 million in Treasury bills, because all United States Steel stock is just like all other United States Steel stock. So it tells you nothing about the identity of the corporation and there is no reason why a corporation which owns only cash or only investment assets should be able to carry a loss with it.

Under present law, while it is not 100 percent clear, such a case would surely be attacked under section 269 which says that if you intend to get the loss, you can't get it, and that can be the only intention of the purchaser. He can buy United States Steel stock or Treasury bills anywhere, he does not need to buy this corporation, and his reason for it must be to obtain the loss. It cannot be anything else.

Please interrupt if you want to ask a question.

On the second page of the material I have submitted there is a short summary sheet showing in effect how the computation would be made. You would begin with the price of the stock. You would begin with that under any approach. Then you would deduct the investments, and that would give you the base on which you operate.

There is one final rule necessary, in some cases. In the famous Alprosa Watch case, which was the horror case in 1948, and has ever since been the horror case that everybody talks about, the corporation was purchased with the business assets in it, but the business assets were sold afterward. As an extension of the investment rule, therefore, you would also have to have a rule that the sale of business assets after the purchase of the stock also diminishes the amount of usable losses.

That is all I would like to say, and I will turn it over to Mr. Bacon.

[The prepared statement follows:]

STATEMENT OF NICHOLAS TOMASULO, ESQ., WASHINGTON, D.C.

SUMMARY

(a) Concept. The extent to which old operating losses may be used when, in a relatively short time, more than 50 percent of the stock of a corporation is transferred should depend on the extent to which the corporation remains the same taxpayer both in size and character.

(b) Operating rule. When there is a 50 percent change in ownership in a short time a corporation only remains the same taxpayer to the extent it retains and continues to exploit its unique business assets. Thus for example a corporation engaged solely in the widget-producing business remains the same taxpayer only to the extent it retains and continues to exploit widget producing assets.

(c) Acquisition price. The amount of loss-carryovers to be allowed shall be determined by the value of all the loss corporation's stock determined solely by reference to the price (in cash or kind) paid for the stock which was actually sold or otherwise transferred.

(d) Adjustment to acquisition price for investments; base for computation of the allowable. The base for computation of the amount of losses allowable must be the acquisition price as determined in (c) deminished by: (i) the fair market value of the investments held by the loss corporation at the time of the sale, and (ii) the amount realized within five years after the change of ownership, on any sale or disposition of business assets held by the loss corporation at the time of the sale.

(e) Amount of loss to be allowed. It is suggested that the total of losses to be allowed be fixed at 100 percent of the base as determined in (d). [The alternative suggestion is that losses be allowable annually in an amount equal to the after-tax yield on the base at prevailing interest and tax rates.]

SUMMARY, Page 2

Table to Illustrate Mechanics of Basic Suggestion

Base for Computing Amount Allowable of Presale (Old) Losses:

Grossed Up Price:		
Amount which would have been paid for 100 percent of the stock of the loss corporation at unit price actually paid		________
Reduction: Loss Corporation's:		
(a) Cash, and cash equivalents	________	
(b) Non-business assets (investments)	________	
(c) Business assets acquired within two years of sale, except those for use in a business in which the loss corporation was engaged before the time of the purchase of such assets	________	
Total Deductions	________	
Total Deductions (subtract)		________
Base (Grossed up price minus deductions)		________
Special Post-Sale Deduction:		
Amounts realized on the sales of business assets of the loss corporation within five years of the sale of the stock	________	
Base, as above adjusted		________

STATEMENT

My name is Nicholas Tomasulo. I am now associated with the firm of Silverstein and Mulens, 1776 K Street, N.W., Washington, D.C. My testimony is not in representation of this firm or on behalf of any client.

It is a great pleasure to be here and I appreciate this opportunity more than I can say. The fourteen years I spent with the joint committee staff were professionally among the most stimulating and pleasant of my life.

Since a short history of the matter and the mechanical and technical details of our proposal appeared in a brief article in "Tax Notes" for Monday, September 12, we respectfully ask that that article be printed in the record. In the interests of brevity this article will be referred to as "B&T page—." Mr. Bacon and I will therefore confine our remarks to a discussion of just three issues.

Mr. Bacon will discuss two items:

(1) The use of a capital limitation rather than an imcome limitation;

(2) The desirability of having a single purchase type rule rather than different rules for purchases and for reorganizations.

I will discuss the treatment of investment assets held by a loss corporation.

I was very glad to see the Committee's announcement pinpoint the issue by inviting testimony as "to what extent if any should a loss corporation which has converted operating assets to passive investment assets be able to retain or transfer its net operating losses." There is no doubt that if we wish to have a truly fair statute this is one of the most important single issues we face.

Digressing just a moment, I am not one of those cynics who believes that fairness has no constituency. On the contrary, I sincerely believe that there are many, many Americans, liberal and conservative, Democratic and Republican, who feel very strongly that above all else, our tax system should be fair to all citizen taxpayers.

The basic construct of fairness is, of course, that one corporate taxpayer should not be permitted to deduct another corporation taxpayer's loss, just as no corporation should be compelled to pay another corporation's tax. Thus the basic issue is one of corporate identity.

Let's now take the example from our own Article: "The Fig family owned all the stock of a corporation which owned a brewery that lost money for many years. Losing hope that the business would recover, the company sold all its brewery assets and purchased a portfolio of stocks and bonds and a medium-sized apartment house. The Newton family then buys all the stock, intending to place a profitable construction business in the loss corporation. It is plain that the new owners are entirely different, the new business is different, and the new business assets are different under the Newtons. The only continuity lies in the corporate charter and in the possibility that the stock certificates are still printed on the same color paper."

Now in what sense is the corporation purchased by the Newton Family the same corporation as the one which suffered the losses? Nothing whatever is the same as it was before except the color of the stock certificates. In every reasonable sense, so far as the losses are concerned, the corporation is a new entity using the old charter the way a Zombie uses the dead body of another person. It is really very hard to see how it can be considered just or fair to permit this corporate Zombie (so to speak) to use the losses of a different corporation whose body (or charter) it appropriated.

But of course it is possible for a loss corporation to become an "incorporated pocketbook" only in part and retain some of its business assets. In such a case the corporate identity must be viewed as surviving to the extent business assets are retained, and as dying to the extent business assets are converted to investments. As must be obvious, this requires that we adjust the purchase price (the base on which allowable losses are to be computed) by subtracting the Fair Market Value of the investment assets. The remainder of the price, after this subtraction, must, of course, be attributable to the business assets. Thus the loss allowable will be in some reasonable proportion to the business assets that the buyer wanted to acquire and did in fact acquire.

It must be realized that the idea that a loss should be permitted to survive only in some reasonable proportion to the business assets is not really a fresh or new thought, but rather a concept which emerges naturally from consideration of the identity of a corporation which has operating losses from the operation of a business. Obviously, when all the stock is sold the character and identity of the corporation is determined by the kind and amount of business assets it is engaged in exploiting. What other standard could there be?

Suppose all the stock of a loss corporation is sold for $600,000. At the time of the sale the corporation owns only stock of General Motors worth $250,000 and all the business assets of a hardware store (which it operates) worth $260,000. Under our proposals the losses allowable would indirectly be measured by the value of the hardware assets—which are assets used in the corporation's unique business and thus define the character, size and identity of the corporation as "a taxpayer." On the other hand, the General Motors stock is just like any other General Motors stock. It is not unique in any sense and tells us absolutely nothing about the history of the corporation. Thus losses measured by the value of the General Motors stock are "Zombie" losses. To allow such losses is a gross and very silly injustice.

The table on the second page of this statement illustrates the mechanics of our proposal. I would like very much to answer your questions about it.

Thank you very much.

STATEMENT OF RICHARD L. BACON, ESQ., BELL, BOYD & LLOYD, WASHINGTON, D.C.

Mr. Bacon. Mr. Chairman, I am going to address the choice of solution that we might adopt for the problem of trafficking in loss carryovers. I was also a member of the Joint Tax Committee staff and succeeded Nicholas in working on corporate tax provisions.

You have heard several references in the Treasury's testimony, and in the testimony of the New York Bar Association and the American Bar Association, to adopting a single rule for all acquisition transactions. That is the type of rule that I wanted to advocate today.

I think, that if you are concerned about the blizzard of paperwork in setting up transactions across the country, one thing you should be interested in doing is avoiding taking that blizzard of paperwork and transferring it from the world of business transactions into the tax statute. I think that if you adopt the proposal set forth in the press release, while its objectives have merit, you are simply going to produce a statute which will achieve nothing but extra work for us tax lawyers in earning fees by trying to explain and work with the unfathomable complexity of rules that are going to be in the statute.

By contrast, I can summarize in one sentence the purchase price rule, which you have heard the Treasury refer to and which, in my opinion, will be equally as effective as the proposal in the press release to stop the abuses in this area and provide practitioners with a rule they can understand and apply easily to actual transactions. The simple rule is the so-called purchase price rule. To explain it in one sentence is nothing more than saying that if an individual, or any party, buys the stock of a loss corporation for, say, $500,000, then, regardless of the amount of the losses available in that corporation, the purchaser can obtain only $500,000 of loss carryovers. That is the end of the rule, and that rule, simply stated, will accomplish the basis policy objective set forth in the press release under what is called the purchase rule and the merger rule.

The simple rule I just stated, limiting the amount of loss carryovers to the price paid by the buyer achieves, I think, the purposes that we want to achieve. That rule assures that the buyer of the loss corporation will pay primarily for business assets, or nontax assets, if you want to include passive investments. It will also assure that the buyer will get no more losses than the loss corporation could have used if no sale had taken place.

You have heard one additional objective set forth here by some who talk about the proposal in the press release; that is to try to limit the amount of loss that the buyer can use every year. The staff pamphlet which has been prepared on this hearing suggests that one defect of the rule that I have just stated is that it permits the buyer to use all the losses at once, that that opportunity is excessively generous, and, that we should try to do something to prevent that. In fact, the purchase price rule limits the buyer to the purchase price, which represents in effect the present value of only an amount of loss carryovers proportional to the expected income from the loss company's nontax assets, and that is all he can get.

Under the American Law Institute's merger rule, in which you allow the losses to be used against a percentage of the acquirer's income, it should be pointed out that the more income the buyer can generate, perhaps by making his preexisting business bigger, or by going out and buying other profitable companies with borrowed funds, the faster he can use the losses; and the more losses he can use in total dollar amount. For the same reason, the merger rule set forth in the proposal also does not restrict the buyer's use of loss carryovers as to timing. The buyer may thus acquire another company and generate additional income from other assets that he has, and thereby use up all of the loss carryovers, and at a faster rate than the seller would have been able to use, rather than being limited to the present value figure which the purchase rule would limit him to.

To the extent that there is some concern that a buyer of a loss company under the single uniform rule I propose would exploit losses which are about to expire, there are compromises you might consider with the purchase price rule, which are extremely simple. The statute might spread the buyer's use of the loss carryovers over 5 years, for example, as the New York Bar Association suggested. It is also possible to limit the buyer not to 100 percent of the purchase price but rather to some percentage less than 100 percent of the purchase price.

The main point is, whatever you do in that respect, that you end up with a rule which is infinitely simpler and easier to apply than the multiplicity of overlapping rules which you see spread before you in the press release. What you have in the press release, if you look through it, is an enormous amount of unnecessary complexity. You have references to "special rules," and "special provisions," which really disguise enormous additional complexity which those of us who work in the technical trenches know would have to be written to carry out the two-part rule, the merger rule and the purchase rule, so called, and other associated rules needed to define terms and provide income tables and rates of return.

All of that can be avoided, however, because the purchase price that the buyer pays reflects all of that by reference to the deal the parties make. You would have an enormous amount of simplicity with a single, uniform purchase price rule. You would also have an equally effective rule. You would have a rule that a Congressman can understand without feeling that the subject is beyond him. You would have a rule that is extremely easy to apply in practice.

I don't mean to disparage a Congressman, but I think that sometimes as you look at the array of technical materials spread before you, such as the American Law Institute proposal here today, your tendency may be to think that because the complexity is there, it all must be necessary, and that somehow there is some wisdom in the American Institute group that perceives something the rest of us do not understand, so it must be necessary. We are dealing here with a very intellectual subject, a very philosophical subject as to what the right answer ought to be. All of us tax people can spend hours debating the issues, and we love to work in the trenches of complexity.

We lawyers as practitioners could also have fun with the array of rules set forth in the proposal in the press release. But if you ask the question, is it all necessary as a policy matter? I think the answer is that it is not necessary, and you can achieve at the same time all of the objectives of preventing trafficking and preventing abuse of tax loss carryovers that we want to achieve.

We have heard a great deal of support for the single purchase price approach from the American Bar Association, the Treasury Department, and from the New York State Bar Association. With that kind of support for a single, uniform rule, I think you would be well on the way to making some progress in this perplexing area of the tax law, including the workability understandability of the rules, while also having equitable and neutral carryover provisions, if you pursue this thread that has run through several witnesses' testimony and adopt a purchase price rule in lieu of the proposal in the press release.

[The prepared statement and attachment follow:]

STATEMENT OF RICHARD L. BACON, BELL, BOYD & LLOYD, WASHINGTON, D.C.

SUMMARY

1. The Proposal's objective is sound insofar as it allows loss carryovers only where the buyer of a loss company pays primarily for business (or other nontax) assets, and limits the amount of losses in proportion to the earnings potential of the company's assets at the time its ownership changes.
2. However, there is no need to go further and limit the buyer's use of carryovers in all cases to the annual rate at which the loss company might have, in theory, used its own losses. The American Law Institute proposal over-theorizes many other issues and is unnecessarily intricate.
3. A better rule to prevent "trafficking" in loss and credit carryovers is a purchase price rule, first proposed in 1958 by the Advisory Group on Subchapter C. This suggestion would treat all acquisitions as purchases and allow the buyer to use carryovers up to (but not more than) the purchase price itself, regardless of whether the consideration is paid in cash, notes or stock. This rule completely avoids multiple different rules, lookbacks, statutory tables, rates, calculations and combinations of limitations required by the American Law Institute proposal. It is easier to understand and apply to business transactions, while being equally as effective as the ALI proposal.
4. Other specific rules in the proposal, especially those dealing with creditors of an insolvent company, are unreasonably harsh.

STATEMENT

Mr. Chairman and members of the Subcommittee, my name is Richard L. Bacon. I am a lawyer engaged in private tax practice in Washington as a partner in the law firm of Bell, Boyd & Lloyd. I am not appearing on behalf of any special interest or group. I was a member of the Joint Tax Committee Staff in 1976 and, for better or worse, participated in developing the 1976 Act amendments to the loss carryover provisions. I testified at this Subcommittee's hearing last year on Mr. Stark's earlier proposal to deal with loss carryovers. Since that time I have chaired a task force within the Tax Section of the American Bar Association which specifically studied the American Law Institute proposal. Our study began more than a year ago and has continued intensively since that time.

We concluded, although I speak here only for myself and for the individual views of the chairman of the Tax Section subcommittee on carryovers, Michael Wasserman, who is here today, that the American Law Institute proposal is very much over-theorized and contains too many unnecessary complexities for what it is supposed to accomplish. We think that all of the basic objectives of the proposal in the press release can be better and more simply achieved through a "purchase price rule" which you have already heard mentioned. That alternative originated right here in the predecessors of this Subcommittee in 1958, when Mr. Mills worked with an Advisory Group of distinguished practitioners and proposed the purchase price rule in a bill, H.R. 4459, introduced at that time.

Very simply, I think we can accomplish everything you wish to accomplish in this area by treating all mergers and other acquisitions as purchases of stock or assest, and limiting carryover deductions to the dollar amount of the purchase price itself. This same, single limitation would apply whatever form of consideration the buyer pays, whether in cash, notes, common stock or preferred stock. If a buyer pays $500,000 for the stock of a loss company, the company could use only $500.000 of its loss carryovers. Since the maximum tax saving from the carryover is 46 percent, or $230,000 the buyer must be paying $270.000 for other assets. Otherwise he will not rationally make the deal. But he cannot acquire loss carryovers alone.

In contrast with this simple rule, there are many firecrackers going off in the American Law Institute proposal and in your press release. We see two entirely different rules, one limiting carryovers after a merger to a percentage of income of the surviving company. A completely different rule would apply where stock is purchased for cash, or notes, or stock in a taxable deal, or preferred stock in a merger. In those cases, your proposal would limit carryovers to an imputed return on the amount of the purchase price. Yet the objective of all this complexity is to end up with the same result as the above example.

To carry out this Rube Goldberg machine, the usual array of mind-numbing baggage comes along. There will be statutory tables for computing the precise amount of income against which losses can be deducted, and special rules for prescribing a Congressionally deemed rate or return on a purchase price. You will have to apply both different rules together in multi-part transactions and in cases where less than all of a loss company's stock is purchased. Numerous special rules will be needed to distinguish common from preferred stock, and to classify hybrid securities, debt versus equity, convertible shares and artifically inflated dividend payments.

I think you should adopt a much simpler rule by viewing the purchase price in all these cases as really a present value summation of the benefits which the buyer expects to obtain from the loss company's carryovers in the future. The purchase price in any business deal always represents the present value of the expected future benefits. A buyer evaluates losses in exactly the same way if the target company has loss carryovers. If we say that whatever amount the buyer pays for the loss company's business assets and tax attributes, that is the amount of carryovers he gets, and he can deduct them as and when income is generated, we sidestep all the complexity of the ALI proposal without really opening up any major abuses that cannot be adequately dealt with.[1]

I share the basic aim of the proposal in your press release to allow carryovers if the buyer pays primarily for business assets, and to limit the new investor to the amount of carryovers which the loss company's assets could probably have absorbed if no sale has taken place. The ALI proposal is really nothing more than a "stretching out" of the buyer's use of the carryovers for as long as they have left to run. Now is this really necessary, or desirable? The main argument I have heard is that this idea is tougher than the purchase price rule, because it limits the buyer not only to the amount of losses which the company was likely to have been able to use otherwise, but it also restricts him to using the carryovers at the same annual rate as the old owners were supposedly able to use them. This is supposed to be a "neutral" rule and it will also prevent sales of a company which has carryovers close to expiring but no income to absorb them.

It seems to me that this is an intellectural refinement which we do not actually need in order to have equitable loss carryover rules and to prevent abuses. In perfectly legitimate sales and purchases of business assets, a buyer who normally pays present value for assets can get whatever income stream he is able to generate, wholly apart from loss carryovers. If a loss is one of the "assets" of the target company, the buyer here should be treated in the same way, I think, if the buyer does what we have already wanted him to do, that is to pay primarily for nontax or business assets. Once he does this, the obtaining of losses is not abusive and we ought to allow the buyer to use the losses without any artificial annual limitation. The loss company itself would not have been so limited, if it had been able to turn things around. The loss company might also have found ways to use its expiring carryovers by accelerating income. This is done all the time and is fully permissible for tax purposes. Shareholders also often contribute new profit-generating assets to absorb expiring carryovers. This, too, is permissible. I see no reason to overkill the buyer in a legitimate case where carryovers are not expiring from using the carryovers as rapidly as the business permits him to do.

---

[1] I have prepared a detailed discussion of this "purchase price rule" with Mr. Nicholas Tomasulo, a professional colleague and another witness here today, which was published in Tax Notes for September 12, 1983, a copy of which is part of this prepared testimony.

We certainly are not adopting a "neutral" rule in any case if we are more restrictive on expiring carryovers than on other carryovers. If there is a residue of doubt about abuses involving expiring carryovers. I suggest that you adopt a purchase price rule but spread the buyer's use of the carryovers over perhaps a five year period. That would have much the same effect as an annual income limitation (to deal with abuses), but it would be far more simple and would avoid unnecessary statutory tables and other bells and whistles.[2]

If you use a percentage of income limitation, notice, too, that the buyer can greatly accelerate and increase his use of carryovers by simply getting bigger by, say, acquiring other companies in other mergers. The increase in total income will increase the percentage of total income which can be sheltered by the loss carryovers. So the ALI proposal will not necessarily limit the rate of the buyer's use of carryovers after all.

Beyond the basic objectives, an example of the many impractical details of the American Law Institute proposal is the idea of comparing the capital that existed in the loss company in each of possibly 15 old "loss years" with the capital in each separate "carryover year." This is an example of pointless theorizing that has very little meaning in the real world. You would look back to income theoretically produced by assets in long ago years and which in most cases will no longer exist. There is simply nothing in this idea, Mr. Chairman, that is practical or necessary, or that connot be equally achieved by looking only to the earning power of the loss company's assets as of the date of a merger or sale of stock. Doing that would greatly simplify the ALI rule for the real world. Of course a purchase price rule, if you choose to accept it, would entirely avoid that unneeded complexity.

The ALI Reporter recently circulated a memorandum among several staff members and a few of us outsiders, in which he acknowledges the advantages of the single purchase price rule Professor Andrews says that the purchase price rule has an advantage in using the same limitation whatever the form of the price paid by the buyer. He now says that the purchase price rule would be as reasonable as the ALI proposal for a wide range of transactions, and that this rule also has another advantage in eliminating any need for Congress to try to specify an imputed rate of return, with whatever approximations and errors that involves.[3] Finally, the Reporter says that the purchase price rule with a limited stretch-out of the buyer's use of the carryovers would deal satisfactorily with the expiring carryover problem. With those kinds of comments, I hope you will pause to consider whether this alternative may not be preferable to the ALI proposal.

I would stress the real advantages of the purchase price rule:

It is much simpler to understand, and to apply to actual transactions than the convolutions and calculations of the ALI proposal.

The purchase price rule is a single rule for all types of consideration paid by a buyer, without complex two-part rules, imputed rates of return, and rules for changing the rate periodically, or statutory tables for computing shares of pre-tax or after-tax income. We avoid special rules, needed under the ALI rule, to deal with abuse cases where the parties use accelerated dividend preferences, inflated face amount notes with loan payments at the end, and other types of "funny" instruments to try to maximize the rate of return formula.[4]

The purchase price rule would be entirely automatic and self-regulating, in ways the ALI rule would not. All rates of return and discount rates are automatically reflected in the purchase price which the parties themselves agree on. Congress need add little else.

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[2] Another argument for allowing losses against an annual income share is that such a rule puts no upper limit on the buyer's use of carryovers. This idea seems to aim at rewarding a new owner who succeeds in turning around a failed business. If you like that type of rule, I suggest we consider adopting a business continuity test and allow new owners to elect to apply a rule rewarding or penalizing them depending on their success in turning around the same business.

[3] The same point applies to the proposed definition of the appropriate income share for mergers by means of a statutory table.

[4] If these types of instruments are taken into account at market value under your proposal, then the ALI proposal has no real advantage over my suggestion in terms of the presence or abuse of valuation questions.

The purchase price rule would also not permit an acquirer to change the rate of using carryovers by changing its own size.

CONCLUSION

Many of us who have studied the ALI proposal feel that a purchase price rule is easier to understand and to apply to real world transactions. It also achieves the same basic objectives as your proposal, without overkilling legitimate cases. I believe that every legitimate problem we are worried about can be solved more simply and equally effectively by the purchase price rule. I hope you will be willing to hear further discussion of the advantages of this alternative before you report out a bill and lock in your views on the subject. The purchase price rule has a distinguished ancestry right here in this Subcommittee.

There are several other policy issues that ought to be more carefully considered, too, such as the proper treatment of creditors who accept stock in an insolvent company. The proposed rule is extremely harsh and runs counter to objectives Congress has adopted for certain kinds of insolvency reorganizations.

If we are going to truly simplify the law, the purchase price rule is far and away your choice, Mr. Chairman. This project will be a good test of what we might expect in this regard as you proceed to revise other business tax rules.

Thank you Mr. Chairman.

tax notes

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TAX ANALYSTS SPECIAL REPORT

NET OPERATING LOSS AND CREDIT CARRYOVERS: THE SEARCH FOR CORPORATE IDENTITY

by Richard L. Bacon and Nicholas A. Tomasulo

Richard L. Bacon is a partner in the Washington, D.C. office of Bell, Boyd & Lloyd. Nicholas A. Tomasulo is with Silverstein and Mullens, also in Washington, D.C. and has taught tax law at Wayne State University Law School. Both formerly served on the professional staff of the Joint Committee on Taxation.

In this article, Bacon and Tomasulo define the concept of "trafficking" in loss carryovers as the obtaining of carryovers disconnected from business assets. They criticize current law's attempts to deal with this problem and propose a new rule that would allow an acquirer to use no more carryovers than the loss company itself could have expected to use if its assets or stock had not been sold.

The authors analyze an American Law Institute proposal to allow carryovers against a percentage of the surviving company's income or against a presumed rate of return on the purchase price of a loss company's stock. They recommend an alternative that would allow carryovers in all cases equal to the purchase price itself. This alternative, they argue, better carries out the objectives of the ALI proposal and is simpler to understand, draft, and apply.

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I. INTRODUCTION

The tax law generally allows corporations and other business taxpayers to use net operating losses, capital losses, and unused tax credits that arise in one year as offsets to income in earlier and later years. Carryovers also cross the lines of corporate fusion in a merger or other acquisition,[1] but sections 382 and 383 expressly limit the survival of operating loss carryovers, capital loss carryovers, and credit carryovers after taxable sales and purchases of stock, redemptions, and reorganizations. The aim is to prevent "trafficking" in losses.

A revision of the carryover restrictions enacted in 1976 has been postponed three times and is currently scheduled to take effect on January 1, 1984. Congress has heard much criticism of the theory behind the 1976 version, and calls to replace it with something else, but no consensus has emerged during the last seven years. The loss carryover issue has a long history, of course, and is still "the most hotly debated of the sore spots in the revenue laws."[2] The arena for debate covers major changes in the life of a corporation such as a reorganization, a purchase of some or all of its outstanding stock, bankruptcy, major changes in the shareholders, or a shrinking or changing of the company's business.

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[1] Carryovers of losses and credits following a tax-free reorganization are generally permitted under Code section 381. The term "loss company" in this article refers to a corporation which, as of the date of a reorganization or other change in control, has unused loss or credit carryovers from one or more earlier taxable years.

[2] Testimony of C. Rudolf Peterson, in Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code, House Ways and Means Committee, 86th Cong. 1st Sess. 418 (Feb. 26, 1959).

Senator Dole's recent call for the congressional tax staffs to review subchapter C has spurred new study of the loss carryover issue,[3] and initial corporate proposals by the Senate Finance Committee staff have already appeared.[4] The time is thus ripe to review the legislative treatment of net operating loss carryovers, and other carryovers, after a corporate merger or change in control of a loss company.

. . .If stock control of a loss company changes hands, the company's net operating loss, capital loss, and tax credit carryovers should survive in an amount equal to the value of the loss company at the date of the acquisition.

At bottom, the loss carryover debate goes to the heart of corporate identity. Why should a corporation be allowed to average good and bad years? To what extent should a corporation be treated as an entity different from a partnership and taxable apart from its shareholders? Should shareholders be viewed as suffering the detriment and receiving the benefit of corporate losses which carry back or forward to offset income in other years? To what extent is "a corporation" the same or different if its shareholders or its business, or both, change? Even where Congress uses the federal income tax law to carry out economic and social policy, an underlying decision is being made as to the degree to which a corporation is itself a source of jobs or economic effects, desirable or undesirable, depending on the company's behavior in the marketplace. The rise and fall of safe harbor leasing during 1981-82 illustrates the length to which the tax system sometimes goes in experimenting with incentives for corporate taxpayers to buy certain kinds of property or to locate in certain places (such as enterprise zones), or to create more equal business opportunities (the level playing field concept) in order to help the national or regional economy. Safe harbor leasing also sought to put cash in the hands of businesses needing some type of financial assistance.[5]

A. Effects of ERTA and TEFRA

The debate over loss and credit carryovers has taken new twists by the fallout from the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). In light of the accelerated deductions allowed in 1981 for depreciation (ACRS), a net operating loss no longer necessarily denotes a company in financial trouble. The investment credit and ACRS deductions were often so large that they exceeded the capacity of some companies, even those not in financial trouble, to absorb them fully—a condition giving rise to "artificial" losses and credit carryovers which reflected timing factors. Through safe harbor leasing, ERTA permitted businesses finding themselves in this position to sell future tax credits and ACRS deductions while retaining actual use of the property. This explicit selling and buying of tax-reducing attributes disconnected from any productive use of the property by the buyer produced large and much publicized tax reductions for numerous big corporations. Perhaps because of the very openness of the approved "traffic" in tax benefits, safe harbor leasing was ridiculed and then repealed in TEFRA.[6] It may be too much to expect that Congress will not continue to use the federal tax system to deliver incentives to particular groups or to discourage behavior or investments by others.[7]

TEFRA did not radically change the accelerated deductions available through ACRS itself, however. For businesses which continue to incur artificial operating losses and tax credit carryovers, particularly in light of ERTA's generosity in lengthening the loss carryover period to 15 years,[8] the Treasury has expressed concern over a possible increase in "tax motivated mergers" in lieu of safe harbor leasing in order for acquirers to benefit from the artificial "losses" which other companies can no longer sell openly.[9]

For some businesses, of course, operating losses are all too real, caused by decreases in earnings. Real economic losses have plagued many businesses in capital-intensive and other industries because of the general recession, shifts in the country's industrial base, high interest rates, the presence (or absence) of regulation in specific industries, and other factors in a changing economy. These factors have pushed the number of business bankruptcies to near all time highs in many industries, including oil and gas, air transportation, steel, farm equipment, and financial services, including banks and savings and loan associations.

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[3] Senate Finance Committee Press Release No. 82-171, October 28, 1982.

[4] See "Finance Staff Makes Recommendations on Subchapter C," *Tax Notes*, August 15, 1983, p. 599. These proposals cover corporate tax rules other than carryovers.

[5] Congress has sometimes used the tax rules on loss carryovers and carrybacks to grant relief to specific companies. In 1967, Congress allowed American Motors Corporation to carry its 1967 and 1968 net operating losses back five years and forward three years. Former section 172(b)(1)(E). Section 374(e) allows participants in the Conrail reorganization of 1976 to "freeze" their net operating loss carryovers and revive them as and when they receive income from court awards or other valuation disputes.

[6] See Lubick and Galper, "The Defects of Safe Harbor Leasing and What to Do About Them," *Tax Notes*, March 15, 1982, p. 643; Ferguson, "Profiting from Tax Losses," 60 Taxes 1010 (1982). Some residues remain in the form of leasing by tax-exempt entities.

[7] See, for example, H.R. 3434, introduced on June 28, 1983, by Reps. Jones and Conable. This bill aims to aid smokestack industries by allowing companies to borrow in cash from the U.S. Treasury up to 85 percent of their unused investment credits. This plan is another way to give money-losing industries the full benefit of tax incentives to invest in new plant and equipment. Cong. Rec., June 27, 1983, p. H-4494. See "Son of Safe Harbor Leasing," *Fortune* Magazine, June 13, 1983, p. 29; Lippman, "Tax Credit Legislation Introduced: Bill Would Give Cash From Treasury to Corporations," *Washington Post*, July 5, 1983, p. D-7, col. 1.

[8] Section 172(b)(1)(B).

[9] See Chapoton, "A Clarification of the New Rules for Tax Leasing," *Wall Street Journal*, Dec. 8, 1981; Moore, "Repeal of Safe-Harbor Leasing May Stimulate Merger Activity," *Legal Times*, Sept. 20, 1982, p. 1; but cf. McDaniel and Surrey, "Tax Expenditures: How to Identify Them; How to Control Them," *Tax Notes*, May 24, 1982, pp. 595, 624.

The potential for tax-motivated mergers involving real troubled companies, and others suffering artificial tax losses, along with Congress's probable unwillingness to bail out more specific companies directly, intensifies the concern over transactions which may be structured by resourceful tax practitioners to join loss and credit carryovers of one corporation with taxable profits of another.[10]

B. Summary of the Proposal

In our view, "trafficking" involves buying tax losses and credits without being primarily interested in acquiring the business of the loss company. An effective rule to prevent this practice (at least in corporate acquisitions) should be relatively simple to understand, draft and apply in practice. It should also be neutral among different types of acquisitions; neutral in neither inducing nor inhibiting an acquisition; and effective in preventing acquisitions solely or primarily for tax attributes. Under these guidelines, and based on prior proposals by groups of scholars and practitioners in the American Law Institute (1982) and in the Advisory Group on Subchapter C (1958), we suggest that if stock control of a loss company changes hands, the company's net operating loss, capital loss, and tax credit carryovers should survive in an amount equal to the value of the loss company at the date of the acquisition. This value will be evidenced by the purchase price paid for its assets or stock, and if less than all the stock is purchased, the company's value will be grossed up from the amount paid for part of its stock. This rule would apply uniformly to taxable sales of stock, infusions of new money into a loss company, and reorganizations. The basic aim would be to allow new owners to use no more of the unused losses and credits than the loss company itself could have reasonably expected to use if the sale had not taken place. This rule, we believe, will make carryovers a neutral factor in acquisitions and block trafficking in tax attributes for their own sake, but will allow a flow of incidental tax items in normal business transactions. The version of this idea we propose will, in contrast to the rule proposed by the American Law Institute, allow practitioners to understand and apply a relativly simple rule.

Proposed statutory language and a technical explanation accompany this article.

II. THE UNDERPINNINGS OF PRESENT LAW

Our tax system decided some time ago to limit the occasional unjust effects of an inflexible annual accounting period by permitting a rough averaging of loss years and profitable years through the use of a net operating loss carryback and carryover from a loss year to a profitable year. Once this benefit is allowed to "taxpayers," however, it becomes essential to allow the deduction only to the same taxpayer who incurred the loss. In the case of individual proprietors, we have not (up to now) had much trouble applying this principle. Corporations present a more sophisticated question.

The structure of the corporate income tax—a tax on the corporate *owner* of income—is such that we cannot escape the conclusion that a corporation in year six is not the "same" as that corporation in year one if, during the five-year interval, there has occurred both a complete change in stock ownership within a relatively short period of time *and* a total change in the business conducted. A corporation engaged in manufacturing widgets, for example, as to which there is a complete (or major) change in stock ownership, remains the same "person" in reality only to the extent that it retains and continues to use widget-producing business assets. The reverse must also be true: the corporation *is* the "same" person as in prior years if (1) its shareholders have not entirely changed, or (2) the business has not changed, or (3) neither the business nor the shareholders have changed in major ways.

...sections 382 and 383 expressly limit the survival of operating loss carryovers, capital loss carryovers, and credit carryovers after taxable sales and purchases of stock, redemptions, and reorganizations.

The above principle has emerged from a long history. In 1934, the Supreme Court solemnly decided that insofar as the significance of the corporate entity in relation to carryovers is concerned, the world was flat as a pancake. In *New Colonial Ice Co. Inc. v. Helvering*,[11] "New Colonial Ice" was a New York State corporation formed to take over the business and assets of "Colonial Ice" (also a New York corporation). The new corporation continued the same business (manufacture of ice) with the same assets and had the same shareholders and creditors as the old. Nevertheless, the court held that New Colonial Ice was a different "taxpayer" because, and seemingly only because, it had a new charter. Accordingly, a loss carryover from the old corporation was denied. While this flat and formal world was a disaster for New Colonial Ice, it turned out to be a rich bonanza in *Alprosa Watch Corp. v. Commissioner*.[12] In that case, a loss carryover was allowed although (1) all the stock of a loss company was sold, (2) all of its business assets were disposed of shortly after the sale, (3) the old business was completely changed from manufacture of women's gloves to the sale of jewelry and watches, (4) the location of the business was moved, and (5) the corporate name was changed. The basis of the decision was that the watch corporation was the "same" corporate person as the glove corporation because (and only because) it continued to hold the same charter.

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[10] *See* Ferguson, footnote 6, *supra*. An additional concern over carryovers stems from enactment of section 338 by TEFRA. Section 338 permits a corporate buyer of 80 percent or more of the stock of a target company to elect a cost basis for the target's assets. May a buyer of stock of a loss company not elect under section 338, promptly liquidate the target company, and claim carryovers via the general rule of section 381? The potential for such easy access to carryovers has already provoked comment. See "Loss carryforwards may be targets for takeovers under the 1982 tax act," Tax Report, *Wall Street Journal*, October 6, 1982, p. 1; Note, "TEFRA opens up loss corporation acquisition benefits," Shop Talk, 58 J. Taxation 399 (1982).

[11] 292 U.S. 454 (1934), affirming 24 B.T.A. 886 (1931).

[12] 11 T.C. 240 (1948).

A. The 1954 Code

Congress decided not to continue living in this formalistic world. Beginning with the 1954 Code, Congress attempted to make the loss carryover world "round" by allowing tax attributes generally to survive a reorganization (section 381) or a taxable sale of stock, subject to limitations of sections 382, 383, and 269.[13]

In light of...ACRS, a net operating loss no longer necessarily denotes a company in financial trouble.

The "purchase" rule of section 382(a) applies if, within a two-year period, 10 or fewer persons purchase more than 50 percent of the outstanding stock of a loss corporation. The loss carryovers are completely eliminated in that case if the corporation does not continue to carry on a trade or business substantially the same as it conducted before the purchase. The reorganization rule of section 382(b) does not take continuity of business into account but looks only to the degree of continuity of stock ownership. The rule provides that whenever a loss corporation is merged with another corporation, the carryovers survive if the former shareholders of the loss company own 20 percent of more of the fair market value of the stock of the combined enterprise; below that minimum level, the carryovers are scaled down by five percent for each percentage point less than 20 owned by the loss company's former owners.[14]

In 1976, Congress revised section 382 (which, as noted, has not gone into effect) to adopt a uniform stock ownership test for purchases of stock and reorganizations. A business continuity test was eliminated. The all-or-nothing rule for stock purchases was also eliminated, and a graduated reduction in the amount of carryovers, beginning if old shareholder continuity is less than 40 percent, was applied to changes in stock ownership by purchase as well as by reorganization.

B. Reasons for Limiting Loss and Credit Carryovers

It is commonly said that loss and credit carryovers must be limited after an acquisition to prevent "trafficking" in tax benefits. Oddly, there is little agreement on precisely what this term means. One notion of a visible evil is the advertised sale and purchase of net operating loss carryovers for considerably less than their full potential tax savings—the proverbial 10 cents on the dollar.[15] This type of "trafficking" occurs most egregiously through sales of shell corporations which contain few, if any, income-producing assets. One school of thought holds that trafficking does not occur even if tax attributes are transferred as disembodied assets apart from income-producing assets of the loss company, *provided* the sellers of the loss are fully compensated by receiving as close to the maximum 46 percent tax saving as possible. It does not follow, though, that trafficking does not occur so long as the sellers receive close to 46 percent for the tax benefits. A different school of thought insists that trafficking occurs if tax attributes are not an incidental part of a larger "package" consisting primarily of assets of an ongoing business, along with tax benefits. Those to whom this concept appeals would not bar sale of a carryover to new investors for a price, or use of the carryover against profits from a different business from that which generated the loss, so long as the tax benefits are related in a reasonable way to the total group of business assets transferred.

...'trafficking' involves buying tax losses and credits without being primarily interested in acquiring the business of the loss company.

For others, trafficking denotes any use of carryovers by a corporation owned by substantially different persons from those who were shareholders when a given year's loss or credit was incurred. This approach looks through the corporate shell and sees its owners as being "the true sufferers of the loss."[16] No trafficking occurs, in this view, if the owners of a money-losing business abandon their existing business and begin a completely different enterprise which produces profits; the same owners ought to be able to offset new business earnings with losses from the discontinued business. However, if a majority of the beneficial owners change, "their" loss should not be available to another group of owners. An extreme expression of this view might be that any purchase of 50 percent or more of a loss company's stock would be deemed, for tax purposes, to be a sale and purchase of assets, with complete disappearance of loss carryovers and other tax attributes of the selling company.[17]

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[13] It has been argued that the averaging rationale does not extend to corporations because corporations pass on their tax burdens to customers, employees, and shareholders, and since these persons change daily, the ultimate payors when the loss was incurred are not the same as the ultimate payors in the carryover year. Fleming, "Reflections on Section 382: Searching for a Rationale," 1979 Brigham Young Univ. L. Rev. 213, 218 (1979). Allowance of carrybacks and carryovers to corporations has been justified on averaging-related grounds: encouraging new enterprises and other types of risk or venture capital; equalizing competition for investment funds between businesses with wide cyclical swings and businesses with stable income; and stimulating investment in periods of recession or financial difficulty. H. Rept. 855, 76th Cong. 1st Sess. (Revenue Act of 1939), 1939-2 C.B. 504, 510-511 (1939); Statement of Richard A. Freling, in Public Hearings on Tax Reform before the House Ways and Means Committee, Part 5, p. 3626 (July 30, 1975).

[14] Section 383 requires the Treasury to prescribe similar rules for carryovers of capital losses and various tax credits, including the investment tax credit, the foreign tax credit and others. Code section 269 also permits the Secretary to broadly override these statutory rules and disallow loss and credit carryovers (and other tax benefits) if tax avoidance is the principal purpose of an acquisition of assets or stock control of a loss company.

[15] Instead of paying the full 46 percent tax saving to be obtained from the carryover, the buyer pays only 10 percent or less and thereby reaps a "windfall" of 36 percent of the dollar amount of the carryover.

[16] See, *e.g.* Asimow, "Detriment and Benefit of Net Operating Losses: A Unifying Theory," 24 Tax L. Rev. 1, 4 (1968).

Still others see loss and credit carryovers as inseparably part of the loss company's business and would allow carryovers to survive even a complete change in stock ownership, but only if the company, in the hands of new owners, continues to conduct the identical business which produced the loss. The case of *Libson Shops, Inc. v. Koehler*[18] is usually associated with the idea that trafficking occurs if the carryovers are offset against a different business from the particular activity (not just a similar activity) which produced the loss.

C. Different Remedies

The major alternatives which have been offered to deal with the trafficking problem are discussed below.

1. Existing Law. Existing law does not reflect any clear concept of the evil to be prevented. The tax rules are different depending on the form which an acquisition takes. If a new investor buys over half the stock of a loss company for cash or notes, as explained earlier, the carryovers survive so long as the existing business is continued for at least two taxable years.[19] Otherwise they disappear entirely. The new owner who continues the old business may, however, contribute an additional business or start a new business within the company and preserve the carryovers against those profits, provided the old business (and not necessarily the one which produced the loss) is also continued at least two years.[20] This is an all or nothing rule. On the other hand, if stock or assets are acquired by another corporation in a statutory merger or other tax-free reorganization, the carryovers depend on whether the former owners of the loss company receive 20 percent or less of the total stock of the acquiring company. The carryovers are scaled down (rather than instantly eliminated) if stock continuity is less than 20 percent. No clear policy explains why, under this rule, carryovers ought to fully survive if the profit company is no bigger than four times the size of the loss company, but not if the size difference is greater. Major loopholes also exist in both sets of rules.[21]

2. Business Continuity. An ordinary sale and purchase of assets for cash does not bring loss or credit carryovers to the buyer, even if the buyer continues the business in which the assets are used. It is also well settled that the owners of a money-losing business can abandon that business and switch to a completely different business and still carry over losses from their old business against profits from the new business. Plainly, for advocates of a business continuity test, more than merely continuing a business must be required. For those who like *Libson Shops*, a change in stock ownership seems equally necessary along with a change in business. In addition, a business continuity test creates difficult factual and definitional problems and also an uneconomic stress on continuing an activity that, in many cases and apart from taxes, ought to be ended.[22]

3. Changes in Stock Ownership. Those who believe that shareholders ultimately "suffer" the corporation's losses or excess credits would tie the dollar amount of an allowable carryover to the degree of change in stock ownership of the loss company. This type of test (currently used in section 382(b)) ignores the separateness of the corporation as a taxable entity. It also requires a point to be fixed where the scaling down of losses begins. That point in turn requires a policy judgment about the relative size of the companies that should be permitted to combine with full survival, or less survival, of attributes. Those judgments do not seem properly made by tax people, and belong more to antitrust policy than tax policy.

It is commonly said that loss and credit carryovers must be limited after an acquisition to prevent 'trafficking' in tax benefits. Oddly there is little agreement on precisely what this term means.

Keying the amount of carryovers solely to the degree of change in ownership is also flawed if a uniform scaledown applies, as under the 1976 version of section 382, to stock purchases and reorganizations. If the shareholders' interests are viewed as indirect ownership of the assets inside the corporate shell, a purchase of outstanding stock divides the loss company's capital, whereas a merger with a profit company creates an expanded pool of capital. There is no equivalence between these two cases that justifies the same scaledown based solely on a uniform percentage of shareholder continuity. A 10 percent continuing interest by the loss company's owners in their own company after a sale of 90 percent of the outstanding stock of the company to an outsider is worth less than a 10 percent continuing interest by these owners after a merger of their company with another company.[23] The old shareholders' continuing indirect interest in their company's assets after a merger is also not accurately reflected by a scaledown according to the shareholders' percentage interest in the combined enterprise.[24]

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[17] Presumably, under such a "mandatory section 338 election," accumulated earnings and profits would also disappear.

[18] 353 U.S. 382 (1957).

[19] Section 382(a).

[20] Reg. § 1.382(a)-1(h)(8).

[21] For example, section 351 transactions and type (B) reorganizations are not covered at all. In a triangular reorganization, the loss company's former owners need only receive stock in the parent company worth 20 percent of the value of the loss company (rather than 20 percent of the parent company).

[22] Most of the litigation under section 382(a) has involved the question of whether a business has been continued or discontinued in specific factual settings.

[23] Suppose for example, that loss company L, having $1 million net worth, merges with profit company P, having $9 million net worth, for 10 percent of the common stock of surviving company, LP. L had a loss carryover of $10 million. Under present law, the carryover would be reduced to $5 million. If the same percentage scaledown were applied to a taxable sale of a loss company's stock, and the shareholders of L sold 90 percent of their stock to a new investor for cash, L's carryover would also be reduced to $5 million. But these two transactions are not the same economically. After the merger, L's shareholders continue to own the same value they owned before ($1 million), while after a taxable sale of 90 percent of their stock for cash, the value of their interest in the loss company is reduced to $100,000. The dollar amount of L's carryover should not be reduced by the same amount in both cases.

4. Free Trade. Those who would remove all restrictions against selling and buying tax carryovers do not object to a sale of disembodied attributes apart from business assets, but simply want the sellers to be compensated as fully as possible. *In this view a new owner of a loss* company should not have to continue the existing business, nor worry about how many former proprietors continue to hold an equity interest. The main point is that the owners of a loss company will possess greater bargaining power, free of legal uncertainties which require heavy discounting, to receive full compensation for their company's losses if they can freely sell them, while also reducing the "windfall" to a new investor.[25] Even under free trade, however, a buyer will discount his purchase price to reflect the risk that he may not earn sufficient income to absorb the carryover, and to reflect his delayed receipt of the benefit until future years. In addition, even if a buyer is paying solely for a loss or credit and for no productive assets, he will also pay less than the present discounted value of the carryover, because otherwise he will merely break even.

Existing law does not reflect any clear concept of the evil to be prevented.

A more substantive difficulty is that free trade departs radically from the averaging rationale for carrybacks and carryovers. Free trade does not require that the new owner earn any income from the company's nontax assets, since the survival of carryovers does not depend on the loss company's business or on the income-earning potential of its assets. Under these circumstances it is not clear why the loss company deserves to be reimbursed for the tax value of its unused losses, even if the losses resulted from incentive-type deductions, tax elections or other timing features. If carryovers are allowed in order to average the income and loss of business assets, or to encourage new enterprises or risk-taking, or to alleviate the competitive effects of business cycles, free trade will assist none of these objectives if the buyer can obtain carryovers to shelter future income from unrelated assets. Free trade also creates a disadvantage for businesses which compete with a business buying a carryover. If profit company P can acquire loss company L and use L's carryovers to shelter P's income, the amount paid for the carryovers represents, in effect, tax dollars that P would otherwise have paid to the Treasury. These dollars are diverted to reimburse private taxpayers for their business losses or for tax incentives (in the form of accelerated deductions) intended for their corporation. The policy question is whether tax dollars should be diverted in this way to what are, in many cases, inefficient or "real" money-losing enterprises. Since P will necessarily pay less than the present value of the carryovers, P's taxes will be lower than the taxes paid by its competitors. These effects suggest that more serious policy considerations are involved than merely the administrative simplicity of a free trade system, or the likelihood that without restrictions the sellers of a loss will be more fully compensated.

On the other hand, we would say that if loss or credit carryovers accompany a sale of a going business or other elements of real economic value, the negotiation of attributes might be defensible as merely an incidental part of the entire "package" being transferred. Under those conditions it would not be wrong to let the buyer pay something for unused losses or credits. Unless our tax system bars all inheritance of tax attributes (including earnings and profits), some permission to "sell" tax attributes must exist, so long as the primary feature of the overall transaction is a transfer of real economic values.

5. Refundability. Some economists and academics argue that we could save the administrative and legal difficulties of policing loss carryovers if the Treasury simply reimbursed business taxpayers directly for operating losses and unused credits. The rate at which these items would be "refunded" in cash would be separately decided, but would reflect a presumed tax value of the loss or credit.[26] This amount would then be paid directly to the sufferer of the loss rather than routed through a third party, as under free trade.[27]

The main argument for refundability appears to be that a patchwork system of refundability already exists for established and diversified corporations and for affiliated groups which file a consolidated return.[28] The opportunity to obtain a refund of past profits or of the profits of another division or subsidiary, it is said, can be viewed as existing reimbursement by the government through a decreased tax on those profits. The tax system would be more "neutral," it is argued, if these favoritisms were eliminated. Our present tax system allegedly also distorts investment decisions away from risky projects by the prospect that the investor will not be able to fully deduct his losses; the existing system also encourages corporate mergers in order to obtain carryovers; and it devalues the tax benefit of carryovers whose use is deferred in a period of long-term inflation. The remedy for all these "defects" is to allow taxpayers to recover currently the tax value of their losses and credits. The tax system would also be more neutral, it is said, if it disregarded the taxpayer's characteristics that are extraneous to a particular investment project. Refundability would also be more cosmetic than free trade, because it avoids any public "marketing" of tax benefits.

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[24] See footnote 42, *infra*.

[25] See, e.g., New York State Bar Association Tax Section, "Report on Section 382 of the Internal Revenue Code as Amended by the Tax Reform Act of 1976," 31 The Tax Lawyer 283, 286 (1978); Aidinoff, "Utilization of Acquired Net Operating Loss Carryovers and the Tax Reform Act of 1976—A Face Lift for Section 382," 55 Taxes 874, 886-888 (1977).

[26] Refunding might occur annually through a payment of part or all of a loss or unused credit directly to the loss company. Instead, the refund might be paid at the date of a merger or other acquisition of the company, or on sale of a certain percentage of its stock, or at liquidation, or at the date unused carryovers would otherwise expire.

[27] Free trade is perhaps less radical than refundability, because the latter system compensates the loss company or its shareholders without a need for any positive income. Under free trade a buyer will benefit from loss carryovers only if his business earns income (or incurs tax liability) to absorb the attribute.

[28] See Campisano and Romano, "Recouping Losses: The Case for Full Loss Offsets," 76 Northwestern Univ. L. Rev. 709 (1981).

. . . for advocates of a business continuity test, more than merely continuing a business must be required. . . . A change in stock ownership seems equally necessary.

The difficulty with all of these arguments is that refunding rests on an incorrect view of many of the basic principles of our tax system. In practice, the idea would also damage the general self-assessment process. The fact that our present system "favors" established, diversified, and/or affiliated companies is less a result of the loss carryover rules than it is of the "one basket" treatment of income and expenses in our tax law. Our system basically taxes *persons* as owners of an aggregate income stream and not the separate income from a particular business or venture.[29] Even in a tax-free world, a diversified company would fare better economically than a one-product company that loses money.[30] Our tax system therefore cannot be held responsible for favoring diversified over undiversified businesses. The real question is whether the tax system should be used, via refunding, to make profitable, taxpaying persons subsidize businesses that incur real economic losses, or to reduce the advantage which diversified and affiliated corporations now enjoy. Whether the loss carryover rules should be used to do this involves nontax policy, but those rules should be viewed as a potential means for changing the one-basket income tax system rather than as part of any loss carryover problem. The tax system would also not operate neutrally if profitable taxpayers effectively subsidized loss businesses through payments from general revenues. It might be predicted, in fact, that use of general revenues to subsidize money-losers might further weaken taxpayer morality (as occurred with safe harbor leasing), and tip the tax system even further away from effective revenue-collecting.

The argument that refundability reduces the advantage of an established business over a new business may also be questioned. A new business obviously lacks earlier profit years to which a current loss can be carried to create a refund. However, the established business that enters a new field, loses money, and generates a refund of past taxes also pays no tax for past years; in this respect the established business is put in the *same* position as the new business—both pay no tax for pre-loss years. The fact that the established company ends up with past earnings which are in effect untaxed reflects the nontax fact that it has been in business longer than the new company. The tax system, however, has not favored the old company over the new company in terms of competitive equality; both companies are in the same tax position, *i.e.*, no tax incurred for pre-loss years and an opportunity to carry the current loss to future years. And insofar as multi-product companies benefit from accelerated deductions more than single product companies do, this is another result of our basic one-basket income tax system; refundability should be compared with direct government subsidies as a delivery mechanism if a change in fundamental concepts is desired.

. . . a business continuity test creates difficult factual and definitional problems and also an uneconomic stress on continuing an activity that, in many cases and apart from taxes, ought to be ended.

Our tax system in fact confers a generous subsidy in not imposing any tax on a taxpayer who suffers a net operating loss while still providing government services to that taxpayer. In this respect, the income tax system is already more generous than an excise tax system, which imposes taxes regardless of the existence of net income or loss, or than a private landlord or other creditor who normally demands payment regardless of his debtor's net income or loss. It is far from clear that a social, economic, or political consensus exists for using public funds to do any more for a money-losing business in the form of reimbursing even part of its losses.[31]

6. Income Versus Capital Limitation. In 1956, the taxation subcommittee of the House Ways and Means Committee appointed a group of private practitioners to recommend amendments generally to subchapter C.[32] The Advisory Group Report[33] recommended a new statutory rule that the carryovers of a loss corporation be limited to 50 percent of the amount paid by the buyer for all the stock (or which would have been paid for all the stock at the rate at which 50 percent or more was purchased). Reorganizations would have been treated as purchases under this rule. For example, if a loss company had carryovers totaling $200,000, the buyer would have to pay (in cash or stock) at least $400,000 to obtain all the carryovers. Since the tax benefit from the carryovers was $100,000 (assuming a 50 percent corporate tax rate), the buyer would have to be paying at least $300,000 for something else, i.e., presumably nontax, income-producing assets. If the buyer paid only $100,000, he could use only $50,000 of carryovers producing a $25,000 tax benefit. Such an acquisition would not make sense for the buyer and, under this idea, would not be rational unless the loss company had other elements of real economic value worth at least three times the tax benefit from the carryover.

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[29] Thus, a tax-exempt organization owes no tax on its income not because of the characteristics of the income, but because of the characteristics of the recipient organization. In general, and with exceptions, individuals and corporations are permitted to net their income and deductions regardless of the source of particular income and deductions.

[30] Thus, if a one-product widget company loses $100 while a two-product company also loses $100 making widgets but earns $100 making gadgets, and assuming a tax-free economy, the two-product company will come out economically ahead because it will have zero net worth while the other company will suffer a $100 deficit.

[31] Some also argue that the government should share equally in profits and losses and that refundability will achieve this result. Yet if the government collects $46 from a $100 profit and reimburses another taxpayer $46 for a $100 loss, the after-tax cash flow to the profitable taxpayer ($54) nearly equals the after-tax cash flow to the loss taxpayer ($46). In this light the government is not the taxpayer's "partner"; it is more like a guarantor or underwriter.

[32] Members of this group were Norris Darrell, chair; Kenneth W. Gemmell; C. Rudolf Peterson; Samuel J. Lanahan; Edwin S. Cohen; Leonard L. Silverstein; and Marvin K. Collie.

[33] The revised report was submitted on December 11, 1958.

Keying the amount of carryovers solely to the degree of change in ownership is also flawed if a uniform scaledown applies, as under the 1976 version of section 382. . . .

The basic aim of the Advisory Group was to allow loss carryovers if the buyer was paying primarily for business assets, and to tie the amount of carryovers to the earning potential of the loss company's assets as of the time its ownership changed. As explained by C. Rudolf Peterson,

> "This would also, you might say, cut a carryover down to size in that if there was a substantial business and you were willing to pay for it, if it had an enormous carryover you would not be losing the whole thing, but would get some part of it, which you might say would be in a way related to the business of the size and prospects it has at the time the ownership changes hands."[34]

In 1982, an alternative proposal was offered by a different group of scholars and practitioners as part of an American Law Institute study of subchapter C.[35] The ALI suggested that, in the case of reorganizations, the old losses of a merged loss company should be allowed each year up to a fraction of the income of the survivor company equal to the percentage of total common stock received by former owners of the loss company.[36] Where preferred stock was issued, or where a new investor purchases more than half of the loss company's stock from existing shareholders, the ALI proposal would limit annual use of the company's carryovers to the after-tax income which the preferred stock or other purchase price would yield at an imputed rate of return on the consideration.

Where less than all of a loss company's outstanding stock is purchased by new owners, a two-step rule would apply. Loss carryovers would be allowed against (a) an interest-like rate of return on the consideration paid by the buyer to the selling shareholders, plus (b) a percentage of future earnings reflecting the continuing ownership of the shareholders, if any, whose stock was not purchased. For example, if a new owner bought 80 percent of the stock of a loss company for cash from existing shareholders, the carryovers would be allowed in the amount of a specified annual return on the purchase price plus 20 percent annually of future corporate earnings reflecting the continuing minority interest.

Both the Advisory Group and the ALI would abandon a business continuity test and a shareholder continuity test. The objectives of both proposals are also the same, although the mechanical rules proposed by each differ. Both proposals aim, at bottom, to limit loss and credit carryovers in the hands of new owners to the income which the loss company's assets might reasonably have expected to earn as of the date of the merger.[37] The Advisory Group would limit carryovers by reference to the price paid for the loss company's assets or stock; the ALI would allow the amount of carryovers to offset each year the percentage share of income allegedly "allocable" to the loss company shareholders' continuing stock interest. ALI points out that if the loss company did not merge with another business, or if it cashed out its existing assets and reinvested the proceeds in an investment paying a fixed rate of return, it is clear that under present law its carryovers could offset those earnings (but no more). Both approaches in effect view a merger, or a sale and purchase of stock, as a form of "investment" of a loss company's assets (capital), after which carryovers should be permitted to offset future earnings deriving from this capital but no more. The expression of this idea builds on the concept originally put forth by the Advisory Group in 1958. Both approaches prevent trafficking in losses because the price which a new owner "pays" to the loss company's shareholders via stock, cash, notes, etc. must exceed the maximum 46 percent tax saving which can be obtained from the carryovers. So a buyer will have to pay primarily for other assets in addition to tax benefits.

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[34] Testimony of C. Rudolf Peterson, Hearings before the House Ways and Means Committee on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code, 86th Cong. 1st Sess. 421 (Feb. 26, 1959).

[35] See American Law Institute, Federal Income Tax Project: Subchapter C, Proposals of the American Law Institute on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions (1982). The reporter for this project was Professor William D. Andrews of Harvard Law School. The proposals relating to special limitations on loss carryovers and related topics appear on pages 198-301 of the volume.

[36] Thus, in a merger where 10 percent of the common stock of the acquiring company is issued to shareholders of the loss company, the full amount of loss carryovers would survive the merger but could be deducted yearly against only 10 percent of the earnings of the acquiring company until the carryovers otherwise expire.

[37] In the case of a merger, the ALI says it also purports to approximate the results of a "joint venture" between the loss company and the profit company or other merger partner. We will comment later on the validity of this analogy. A purchase of the outstanding stock of a loss company does not expand the capital of the company at that time, but if a new owner acquires over 50 percent control, he is *potentially* likely to contribute new assets into the company. The ALI proposal would therefore limit carryovers when more than 50 percent of a loss company's stock is sold to new investors on grounds of the *potential* expansion of assets.

III. A PROPOSED PURCHASE PRICE RULE

A. In General

Standing on the shoulders of those who have gone before, we have tried to discover a sensible and practical approach to the loss carryover problem. So ~~long as~~ Congress allows tax attributes to cross lines of corporate fusion and to survive stock sales and purchases (except where the taxpayer elects otherwise under section 338), we need a rule to prevent unrestricted dealing in losses and also their total destruction upon a change in control of a loss company. In our opinion, carryovers should not be conditioned on continuation of any particular business. Nor should the amount of carryovers depend directly on the percentage of continuing old shareholders.

A neutral rule would allow a new owner of a loss company to use no more carryovers than the loss company itself could reasonably have expected to use based on the size and earnings "prospects" of its assets at the time of sale. This is the common objective of the Advisory Group and ALI proposal, whose seminal expression appears in Rudolf Peterson's statement quoted earlier. If we use a gross (capital) limitation, the ceiling on carryovers will be equal to the value of the loss company at the time a major change in control of its stock occurs. On the other hand, if we seek an annual income limitation, the annual ceiling will be the after-tax income which the purchase price will yield at an assumed rate of return.

Unless our tax system bars all inheritance of tax attributes . . ., some permission to 'sell' tax attributes must exist, so long as the primary feature of the overall transaction is a transfer of real economic values.

For reasons to be explained, we believe that a capital limitation is better in achieving the desired objectives. If all the stock or assets of a loss company change hands, losses should be allowed in an amount equal to (and no greater than) the purchase price paid for the stock or assets of the company. This rule would apply uniformly to taxable sales and purchases of stock of a loss company, tax-free reorganizations, new issues of stock in exchange for new money or property, and changes in control by a redemption of existing shares. This approach is neither "liberal" nor "strict," but merely includes rules which flow naturally and rationally from careful observation of the round world. Inevitably, such a rule (like the ALI proposal) will be triggered by changes in the stock ownership of a loss company. But our proposal would not limit carryovers according to the degree of change in shareholders (as under present law); it would use changes in ownership only to determine when a loss company's assets have been combined with another company's assets (currently or potentially) to warrant immediate action to prevent "trafficking" in losses.

There are two focal points that should be kept in mind: (a) the quantity of the loss company's assets, and (b) the quality of these assets. We will attack the quantitative problem first, assuming we are dealing with loss companies that have only income producing business assets and no cash or investments.

B. Objective Factors

How do we ascertain how much loss the company should be permitted to use after a transfer of its assets or stock? On the basis of some simple and practical assumptions, the fair amount of losses to be allowed can be readily determined.

Some economists and academics argue that we could save the administrative and legal difficulties of policing loss carryovers if the Treasury simply reimbursed business taxpayers directly for operating losses and unused credits.

Assume a buyer who desires to receive a $1 million annual income stream after taxes in a 10 percent market where the corporate tax rate is 46 percent. If the buyer considers acquiring a company having no loss carryovers, he will pay up to $18.5 million for a company having $18.5 million in net assets.[30] The purchase price represents the present value of the annual after-tax income stream to be received in the future. The buyer could also obtain the same annual after-tax income by buying a company having loss carryovers and fewer business assets. If the broker showed him a company having only $10 million in net assets but abundant loss carryovers lasting forever, the buyer could obtain the same $1 million income annually for his $18.5 million purchase price ($1 million tax-sheltered earnings yearly on $10 million assets). An outsider cannot determine what deal the buyer and seller made, however. We do not know what annual after-tax income stream the buyer desires; or why he may choose to acquire the loss company or what its assets or carryovers are; or how the parties allocated the purchase price between assets and tax benefits. Nevertheless, an objective rule is needed to assure that if the buyer chooses the loss company, he pays primarily for nontax assets. This rule can be based on our knowledge of (a) the prevailing rate of return on investments generally, (b) the current corporate tax rate, and (c) the acquisition price.

As noted, the purchase price paid by the buyer of an entire company represents the present value of the expected future after-tax income stream from the acquired company's assets. One who buys all the stock of a corporation that has no losses, at a given price, P, expects that company to have assets equal in value to the purchase price which will yield a stream of annual taxable income at an expected rate of return *ER* equal to P x *ER*. At a tax rate of T, this produces an *after-tax* income stream equal to $P \times ER \times (1-T)$. It is always true that:

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[30] The taxable income required to produce $1 million after taxes is $1 million divided by .54 (assuming a 46 percent corporate tax rate), or $1,851,850. In a 10 percent market such a stream of after-tax income is worth 10 times that sum, or $18,518,500.

P = present value of $[P \times ER \times (1-T)]$ per year, forever. If, however, a corporation has abundant loss carryforwards for 15 years (which we will treat as forever), its after-tax income, $P \times ER \times (1-T)$, will also be its pre-tax income *and will also equal* the amount of annual loss carryover to be deducted. Loss carryovers will produce the same after-tax income stream as a nonloss company from business assets (*BA*) worth less than P as follows:

$$BA \times ER = P \times ER \times (1-T)$$

The buyer may choose to obtain his desired after-tax income stream by acquiring a nonloss company having more assets or a loss company having fewer assets but tax loss carryovers. How do we prevent abuse if he chooses to acquire the loss company?

If there had been no change in control of the loss company and no new assets are transferred into it, the maximum amount of loss it could use each year would equal the income produced by its productive assets, which is either $[BA \times ER]$ or $[P \times ER \times (1-T)]$, indifferently. Thus, it would seem appropriate to allow a loss company, after an actual or potential mixing of its assets with another group of assets, to use the same annual stream of loss carryovers, namely, $P \times ER \times (1-T)$, which it could have used if no change in ownership had occurred. It follows that the nontax assets acquired by a buyer who wishes a desired after-tax income stream, and chooses to obtain that stream from a loss company, must be at least $P \times (1-T)$.

Under an ALI-type income limitation, the annual carryover deduction would be limited to the after-tax yield at the prevailing rate on the purchase price paid for the loss company.

> *Example:* A buyer purchases all the stock of a loss company. P = \$18.5 million. ER = 10 percent. T =46 percent. Under an ALI limitation, the annual deduction is limited to the after-tax income which the purchase price would produce in a 10 percent market and with a 46 percent tax rate. This is \$18.5 million x 10 percent x (1-.46) =\$1,000,000 annual taxable income to absorb carryovers. Minimum assets: \$18.5 million x (1-.46) = \$10 million.

For several reasons it seems to us simpler and more equitable to convert this annual stream of loss deductions into a present value. Identities in the above formulas give us a present value of an annual stream of losses of $P \times ER \times (1-T)$ equal to the purchase price, P, paid by the buyer. It is apparent that when all the stock of a loss corporation, which has only business assets, is purchased for P dollars, the amount of total loss carryovers which the corporation should be permitted to use at once is 100 percent of the acquisition price.[39] This is the present value of an imputed future income stream from the company's assets, and can be referred to as a capital limitation. In the above example the total limitation on losses would be \$18.5 million. At a 46 percent corporate tax rate this deduction cannot be worth more than \$8.5 million to the buyer. Accordingly, the buyer clearly will insist on obtaining at least \$10 million in nontax assets, just as he would under an income limitation.

C. Operation of the Limitation

It is easy to see that the annual benefits allowed under an income or capital limitation are essentially the same. In the example given above, the comparative results would be:

(a) *Income limitation*

Annual deduction = \$1,000,000. This is also the annual after-tax income stream. This amount will yield an after-tax increase in annual income of \$1,000,000 x .46, or \$460,000. This income lasts up to 15 years.

(b) *Capital limitation*

Current deduction = \$18,500,000.

If we assume that the entire deduction is taken currently and the tax saving (\$8,510,000) is invested at a 10 percent rate, the annual increase in the after-tax income stream will also be \$460,000, computed as follows:

\$8,510,000 x 10 percent x (1-.46) = \$460,000

This income stream goes on forever.

If we assume that 15 years is forever, the results under both rules are the same. The increase in the company's annual after-tax income stream (\$460,000) is the same as the maximum increase in annual after-tax income which the carryovers would have created for the loss company had the sale not occurred and if no new assets were contributed to it. The corporation will never be able to exploit a loss which it could not have exploited before the ownership changed hands.

Both the Advisory Group and the ALI would abandon a business continuity test and a shareholder continuity test.

Notice that although in reality we do not know what assets the loss company owns, the buyer in our example will have had to pay at least 54 percent (\$10 million) of the purchase price for the assets and no more than 46 percent (\$8,518,500) for losses.[40] If the loss company had no assets and were merely a shell, a buyer who pays 10 cents on the dollar, hoping to obtain \$50 million in carryovers, will obtain only \$5 million under our proposal and would lose money. The maximum tax benefit he could obtain by contributing his own profit-generating assets into the company is 46 percent of \$5 million, or

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[39] The resemblance to the 1958 Advisory Group proposal is obvious, except that we would eliminate the requirement of a 3:1 ratio between productive assets and tax savings. By allowing carryovers equal to the acquisition price, we ensure that, at a 46 percent maximum corporate tax rate, the buyer will insist on getting at least 54 percent of his purchase price in nontax assets, just as he would under the income limitation proposed by the American Law Institute.

[40] Under both an income or capital limitation the buyer will not pay more than 185 percent of the value of the loss company's nontax assets. Otherwise he will lose money economically. If, in our example, the buyer paid \$20 million for the loss company's stock, the company could use \$20 million in carryovers. However, the maximum tax saving from use of that amount of loss carryovers would be \$9.2 million. Since the buyer also obtained \$10 million in nontax assets, he lost \$800,000 on the transaction.

$2.3 million. For that the buyer would have paid $5 million.

In the real world, a buyer in our example who pays $18.5 million for the stock of the loss company has merely broken even. Since he has paid full value for the losses which the company itself could have exploited, we will allow him all of those losses (but no more). However, a real buyer will want to do better than break even. If a good bargainer buys all the stock of the loss company in our example for $15 million, believing he can (but for a tax obstacle) obtain $10 million in assets and $50 million in loss carryovers at 10 cents on the dollar, the annual deduction under the ALI rule will be $810,000 and the annual tax saving for 15 years will be $372,600. A capital limitation will allow the company an immediate deduction of $15 million, and if we assume that the entire deduction is used at once and the whole tax saving ($6.9 million) is invested at a 10 percent rate, the annual increase in the company's after-tax income stream will also be $372,600. This is less than the increased income ($460,000) which the company would have received from its own carryovers before the sale of stock. But since the buyer paid less than full value for the usable loss, it is fair to cut down the ultimate after-tax benefit to the company under his ownership (as an income or capital limitation would do).

D. Comparison and Comments

A purchase price limitation has all the advantages and none of the disadvantages of an income limitation. It has its own special advantages. It is simpler to understand, to draft, and to apply in actual practice.

1. Rationale. A purchase price rule avoids the inaccurate rationale offered by the ALI that carryover losses will be deducted against income "allocable" to the loss company's shareholders, or that a merger can be analogized to a joint venture between loss and profit companies. In a statutory merger the benefit of carryover-sheltered income inside a corporation flows pro rata to all shareholders, and in reality the loss company's shareholders are selling part of their interest in their company's losses to the other company's shareholders.[41] The setting of exchange ratios reflects a present value evaluation of the losses by the parties in order to divide their tax benefit between the seller and the buyer. The better rationale for both an income limitation or a capital limitation is that the buyer can acquire and use no more losses than the loss company's assets were otherwise likely to have earned, *regardless* of the percentage division of benefit from the losses between the old and new owners of the loss company's assets.[42] A capital limitation thus carries out more logically the American Law Institute's own objective to limit carryovers by the profit potential inhering in the loss company's nontax assets.

2. Neutrality. A capital limitation might be thought to encourage some acquisitions which might not otherwise occur by allowing a buyer to deduct loss carryovers in full immediately against the buyer's own income. Thus it may be feared that loss companies that are near the end of their carryover period and unable to use their own benefits will be tempted to advertise for a buyer who has current income. A way to discourage such sales is to stretch out the buyer's use of the carryover.[43] In the real world, however, the feared abuse is not likely because, with extension of the carryover period to 15 years, a failing company will expire before its loss carryovers do. In practice, we think both alternative rules will be equally neutral in neither encouraging nor discouraging an acquisition.

A capital limitation will also not destroy or adversely limit carryovers which reflect accelerated deductions such as ACRS, but will in effect convert the potential continued use of the carryovers reflecting those deductions into a present value which may be utilized following a change in control of a loss company.

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[41] A merger is essentially an exchange by the shareholders of each company of an indirect interest in part of their company's assets for an indirect interest of equal value in the other company's assets. Assume that loss company L, worth $100, merges with profit company P, worth $900, in exchange for 10 percent of the stock of the survivor, LP, whose total net worth after the merger is $1,000. Because corporate assets and the income they produce inside a corporation are not specially allocated between or among the shareholders, the tax benefit of a carryover flows out pro rata to all shareholders, including former owners of the profit company. The $100 worth of LP stock received by L's former owners in the example does not represent a continuing interest in 100 percent of L's former assets, but rather represents a 10 percent interest (worth $10) in L's former assets plus a 10 percent interest (worth $90) in P's assets. The tax benefit of a carryover against, say, 10 percent of LP's income is not confined to L's former owners. P's owners receive 90 percent of the benefit of the 10 percent income share supposedly "allocable" to L's former owners under the ALI proposal.

The ALI Reporter acknowledges that carryovers will not actually be deducted against a segregated portion of post-merger earnings but will be deducted against the earnings generally. However, the Reporter says "it does not seem unreasonable to suppose that [the deduction's] value will get taken into account in setting exchange ratios, with the result that shareholders of the loss corporation will ultimately be the major ones to benefit from allowance of the deduction." ALI Report, p. 226. The Reporter seems to see that, in reality, the loss shareholders are selling an interest in their company's tax attributes, but he fails to see that if those shareholders end up with less than 50 percent of the surviving company, the other company's shareholders are the major ones to benefit from the deduction.

(Footnote 41 continued top of next column.)

(Footnote 41 continued.)

[42] Oddly, after a merger, ALI would look to the percentage of stock in the survivor held by persons who were shareholders in each loss year when losses were incurred. After criticizing the notion that shareholders beneficially "own" a corporation's losses (ALI Report, pp. 220-225), it is inconsistent to tie an income share to the degree of continuity of stock ownership by the same persons between each loss year and carryover year. Even if ALI is striving for continuity of *capital* between these years, such a rule is inconsistent with the rationale of viewing a merger as a new investment of the loss company's existing capital. Also, why trace old assets which may have long since ceased to exist? Such a rule would also be incredibly difficult to administer in practice. A purchase price rule avoids ALI's over-theorizing and unnecessary complexities.

The example in footnote 41 also shows the fallacy of a shareholder continuity test under present law. The L shareholders' 10 percent interest ($100) in LP consists of a continuing 10 percent interest ($10) in L's assets plus a 10 percent interest ($90) in P's assets. As a percentage of the combined enterprise, the L shareholders' continuing indirect interest in their former assets is only 1 percent (10/1000) rather than 10 percent.

[43] One possibility is to allow, say, 20 percent in the first year after a sale, 40 percent cumulatively after the second year, 60 percent after the third year, 80 percent after the fourth year and 100 percent after the fifth year.

3. Self-Regulating Features. A single purchase price rule is also preferable to separate rules (as proposed by ALI) for purchases and reorganizations. Under a purchase price rule Congress would not have to decide on a rate of return, and how to vary the rate, to be imputed to a purchase price. The parties' own deal automatically reflects a discounting to present value, and the higher the discount rate used by the parties themselves the lower the purchase price, and in turn the lower the amount of carryovers allowed. This rule is thus self-regulating (unlike the ALI rule). An income rule also creates its own technical complexities in calculating the appropriate income share for mergers and continuing minority shareholders; indeed, the ALI report spells out two alternatives in this regard, one of which involves circularity in allocating after-tax earnings. These difficulties would be entirely avoided by a capital limitation.

4. Valuation. Valuation of notes or stock may be required in some cases under an income or capital limitation. Under the ALI proposal, for example, if the acquiring company in a merger has more than one class of stock outstanding, it will be necessary to value the stock received by the loss company's shareholders in order to determine the income share against which carryovers can be deducted. But the difficulties in this regard should not be exaggerated. Under a purchase price rule, where the buyer pays in kind, i.e. stock, notes or other property, valuation questions will be limited to relatively few situations. Publicly traded stocks or notes are readily valued. In taxable sales between closely held companies, values arrived at in arm's length negotiating between parties with adverse interests are normally close to real market values, and in any case the seller must ordinarily determine the value of property received in order to report his gain or loss for tax purposes.

If less than all of a loss company's stock is bought by new owners, we would "gross up" the purchase price for the portion purchased and determine the entire value of the company by reference to the same price per share, which is the best indicia of value. The Advisory Group first proposed this in 1958. It would avoid the ALI's complex two-step rule for partial purchases. A gross-up will automatically deter abusive undervaluations of the assets and tax attributes of the loss company because the lower the amount paid by the buyer, the lower the total acquisition value of the company and the lower the survivable carryovers.[44] The buyer's incentive under a gross-up rule will be to increase the amount he pays, to come closer to a fair price for the entire company. A gross-up rule will also induce a buyer not to utilize unusual debt instruments, such as high face amounts with balloon payments and/or increasing interest rates, because value-depressing provisions such as these will instantly reduce the value of the purchase price and reduce the grossed-up acquisition value. Because the taxpayer will be induced to argue for a *higher* purchase price, and the Internal Revenue Service for a *lower* price, this reversal of the usual adversary positions will pressure taxpayers to utilize more conventional debt instruments and avoid arguments over value.

...our proposal...would use changes in ownership only to determine when a loss company's assets have been combined with another company's assets...to warrant immediate action to prevent 'trafficking' in losses.

5. Exactness. A purchase price rule will allow carryovers to be used normally as fast as income can be generated to absorb them, rather than against an artificially limited income share each year. However, the total amount of deductions will be based on the present value of the future income stream as envisioned when the acquisition occurred, rather than as the parties manipulate assets thereafter. Some may claim that an income limitation is preferable on grounds that allowing losses against the actual income stream (rather than a discounted present value) rewards a new investor who succeeds beyond expectations in turning around a failed business. This argument brings back a nonneutral tax rule and perversely rewards a person who least needs it. It simply gives the buyer an undeserved windfall. If such a windfall is desirable, we should shift entirely to a business continuity test and let carryovers ride up, or down, depending on the buyer's turnaround efforts.

Some also argue that a purchase price rule only "approximates" the income produced by the loss company's assets, while an income limitation is "exact." It is certainly not true that the income rule applies only to actual earnings from the loss company's assets, since even if these produce no income after a sale, the ALI rule would still allow deductions against a percentage of the other merger partner's assets. Further, most sales and mergers are closed transactions based on present values which the parties negotiate at the time of sale. Unless and until contingent stock deals become the norm rather than the exception, a capital limitation is more consistent with actual business practice and would neither increase—nor decrease—the carryovers depending on actual earnings from the loss company's assets or changes in the marginal tax rate.

E. Business Assets v. Investment Assets or Cash

The qualitative issue is whether the loss company or its successor should be entitled to use the same amount of carryovers it could have otherwise used, regardless of the kind of assets it owned when the sale occurred, or whether the statute should focus on income prospects from business assets only. This issue tests the basic rationale of an income or capital limitation. It also bears on abuse possibilities where the assets of a loss company are artificially inflated before a sale by a contribution of business assets by the owners of the loss company. Potential new owners might also direct the company to use its surplus cash to purchase business assets desired by the buyer. Or, after acquiring assets or stock, the new owners may promptly dispose of all of the loss company's assets and use the proceeds in their own preexisting business.

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[44] The Advisory Group considered a two-part rule in lieu of a gross-up, allowing carryovers on account of income allocable to stock retained by minority shareholders. This idea was rejected on grounds that "the retained carryover so measured would benefit principally the new owners, not the old." Revised Report on Corporate Distributions on Adjustments, Subchapter C Advisory Group, December 11, 1958, p. 98.

One possibility is to subtract cash and investment assets held by the loss company on the date of sale, business assets acquired within a short period before the sale, and the proceeds of asset dispositions within some period after the sale, from the aggregate purchase price.

If the basic idea behind a limitation is to allow carryover of attributes in an amount equal to those the loss company could have otherwise used, however, it is arguable that we should not subtract investment assets, because present law would not have prevented the loss company from applying its carryovers against investment income, even if that had become its only earnings. A business asset exclusion might also induce a failing business to hold on to properties which, economically, it ought to sell. And, without special rules, there can be definitional problems in distinguishing between business and investment assets.

The corporate identity issue underlies much of this, along with abuse possibilities. Assume, for example, that the Fig family owned all the stock of a corporation which owned a brewery that lost money for many years. Losing hope that the business would recover, the company sold all its brewery assets and purchased a portfolio of stocks and bonds and a medium-sized apartment house. The Newton family then buys all the stock, intending to place a profitable construction business in the loss corporation. It is plain that the new owners are entirely different, the new business is different, and the new business assets are different under the Newtons. The only continuity lies in the corporate charter and in the possibility that the stock certificates are still printed on the same color paper. In the extreme, if the company's assets had been reduced entirely to $1 million cash and the Newtons paid $1 million cash for all the stock, the purchase really cost the buyers nothing. A spectrum of other assets nearly as liquid, such as stocks and bonds, can also exist, along with other investment assets more or less liquid and more or less passive.

. . . the purchase price paid by the buyer of an entire company represents the present value of its expected future after-tax income stream from the acquired company's assets.

If no concern is shown for these items, and for the possibility of pre-sale and post-sale movements of assets, great slippage will occur in the effectiveness of an income or capital limitation. In *Alprosa Watch,*[45] two days after two new owners bought all the stock of a loss company for $22,000 cash, all the corporate assets (used in a glove business) were sold for $22,000 cash plus $10,000 assumed liabilities, and the proceeds were used to begin a watch business. The court allowed the corporation under its new owner to apply operating losses from earlier years against the later profits. The new owners obviously purchased the loss company in lieu of creating a new corporation because of the tax benefits, which, the facts show, cost the buyer nothing. Was the corporate "person" the same after the shift to completely new owners, name, location, assets and business? Would an income or capital limitation ensure that the buyer in this case pays primarily for nontax assets?

A purchase price limitation has all the advantages and none of the disadvantages of an income limitation. It is simpler to understand, to draft, and to apply in actual practice.

Most cases may not be this extreme. But there is a continuum of identity loss and potential abuse. Even though a loss company could have clearly used its carryovers against investment income if no acquisition had occurred,[46] some compromise with pure theory seems essential. We would subtract from the value of a loss company all cash and cash equivalents owned at the date of the transaction; the value of any personal holding company-type assets whenever acquired; and business assets acquired as a contribution to capital or in exchange for stock within 24 months before the sale. Proceeds from a sale of business assets during five years after the transaction (other than in the ordinary course of business) would also be subtracted. To alleviate hardship, the Treasury would be allowed to exempt taxpayers who could show that the company recently acquired property as part of a legitimate plan to solve serious financial difficulties.[47] These ideas are not intended to require a *Libson Shops* type of business continuity; but some level of generic business activity must be required if corporate identity is to be preserved and either an income or capital limitation is to achieve the goals we have outlined.

F. Summary

A purchase price limitation is simpler to draft and apply to actual transactions than an income limitation. It automatically assures that the loss company will have business assets worth more than half the purchase price, and that carryovers will be usable by the new owner in no greater amount than those assets would have produced without any sale of the company.

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[45] Footnote 12, *supra*.

[46] Cf. Rev. Rul. 67-186, 1967-2 C.B. 81 (under section 382(a), if a new party buys more than 50 percent of the outstanding stock of a corporation which owns only portfolio securities, the loss carryovers produced by a discontinued business will not be allowed).

[47] The Advisory Group would have subtracted assets acquired within six months before the sale. The ALI proposal, by contrast, would exclude all capital contributed to the loss company after the year when each loss within the carryover period was incurred. This impractical idea is also inconsistent with the ALI's own basic rationale that a merger or purchase of more than half of a loss company's stock is a discrete event representing a pooling of capital as of that time with another company's assets. See ALI Report, pp. 225, 230, 240, 242.

PROPOSED STATUTORY DRAFT OF PURCHASE PRICE RULE FOR LOSS AND CREDIT CARRYOVERS

SEC. 270. LIMITATION ON ALLOWANCE OF NET OPERATING LOSS, CAPITAL LOSS, AND CREDIT CARRYOVERS

(a) General Rule.—In the case of a change in control of a corporation, the amount of—

(1) Net operating loss carryovers;

(2) Net capital loss carryovers which can otherwise be carried forward under section 1212; and

(3) Credit carryovers which can otherwise be carried forward under Part IV of Subchapter A and under section 904(d)

of the corporation (referred to hereafter as the "loss corporation") from a pre-change taxable year to a post-change taxable year shall not exceed an amount equal to the acquisition value of the loss corporation. For purposes of the preceding sentence, the term "pre-change taxable year" means a taxable year of a loss corporation ending before the taxable year in which a change in control occurs. The term "post-change taxable year" means the taxable year of a loss corporation which includes a change in control, and subsequent taxable years.

(b) Change in Control Defined.—

(1) In General.—For purposes of this section, the term "change in control" means—

(A) a purchase of outstanding shares from one or more shareholders, a new issue of shares by the loss corporation in exchange for consideration (including an exchange to which section 351 applies and a recapitalization described in section 368(a)(1)(E)), or a redemption of outstanding stock of a loss corporation, as a result of which any one or more of the shareholders on the last day of the taxable year own a percentage of the total outstanding stock which is 50 percentage points or more in either total fair market value or voting power than the same percentage owned by the same persons at the beginning of that taxable year, or at the beginning of the first or second preceding taxable years; or

(B) a reorganization (within the meaning of section 368(a)(1) other than subparagraph (E) thereof) of a loss corporation, as a result of which the shareholders (immediately before the transaction) of the loss corporation own (immediately after the transaction) less than 50 percent of the total voting power or less than 50 percent of the fair market value of all outstanding stock of the acquiring corporation or of a corporation in control of the acquiring corporation; or

(C) any combination of the transactions described in subparagraphs (A) and (B).

For purposes of this subsection, the term "purchase" means an acquisition of stock the basis of which is determined by reference to its cost to the holder thereof.

(2) Exceptions.—Paragraph (1) shall not apply to changes in control resulting from—

(A) Acquisitions of stock by any person who owns, on the last day of the taxable year, less than 5 percent of the total fair market value of the outstanding stock of the corporation;

(B) Transfers of stock between persons who are each actual or constructive owners of such shares under the rules prescribed by paragraph (3) of subsection (e), or from transfers of stock in connection with a divorce, separation or similar marital event;

(C) Transfers of stock to the extent that the basis thereof is determined under section 1014 (relating to property acquired from a decedent) or section 1015(a) or (b) (relating to property acquired by gift or transfer in trust), or from transfers of stock in satisfaction of a right to receive a pecuniary bequest;

(D) A redemption to pay death taxes to which section 303 applies;

(E) Acquisitions of stock or of an increased percentage interest by a trust which is exempt from tax under section 501(a), or by one or more persons who were full-time employees of the loss corporation continuously during the period of 60 months ending on the last day of the taxable year (or continuously during the period of the corporation's existence, if shorter);

(F) Acquisitions of stock by a creditor of the loss corporation in exchange for a creditor claim against the corporation, but only if the claim was not acquired for a purpose to obtain such stock, and only if the stock is received pursuant to a plan for rehabilitation of a financially troubled business in which holders of a majority of creditor claims by number and amount participate; or

(G) A reorganization which qualifies under section 368(a)(3)(D)(ii).

(c) Acquisition Value Defined.—For purposes of this section, the term "acquisition value" means the unadjusted acquisition value (as defined in paragraph (1)), computed with the modifications described in paragraph (2).

(1) Unadjusted Acquisition Value.—

(A) Purchases, Etc.; Gross-Up.—In the case of a change in control resulting from a transaction referred to in subsection (b)(1)(A), or from any combination of such transactions during any period of 36 consecutive months, "unadjusted acquisition value" shall be determined as follows.

(i) The aggregate price paid by the person or persons who acquire stock of the loss corporation (plus the entire amount paid by the corporation for shares redeemed, if any) will be divided by the sum of the number of shares acquired plus the number of shares redeemed, if any;

(ii) The result in (i) will then be multiplied by the total number of shares actually outstanding after the transaction, and

(iii) From the figure reached under (i) and (ii) there will be deducted the sum of all money or property paid in to the loss corporation in exchange for treasury shares or newly issued shares.

(B) Reorganizations.—In the case of a reorganization referred to in subsection (b)(1)(B) in which stock is received or retained by shareholders of the loss corporation, "unadjusted acquisition value" will be deemed to be equal to the fair market value of such stock plus the amount of money and the fair market value of other property, if any, received by shareholders of the loss corporation.

(2) Modifications.—The unadjusted acquisition value determined under paragraph (1) shall be reduced by:

(A) Cash and cash equivalents.—The amount of cash (plus current receivables and minus current payables) owned by the loss corporation at the date of the change in control; and by

(B) Nonbusiness assets.—The fair market value of—

(i) assets of the kind which produce personal holding company income (as defined in section 543(a)), owned by the loss corporation on the date of the change in control, but without regard to whether or not the corporation is in fact a personal holding company as defined in section 542; and

(ii) business assets acquired within 24 months before the date of the change in control as a contribution to capital or in exchange for stock of the corporation.

Subparagraph (B) shall not apply to the extent the taxpayer establishes to the satisfaction of the Secretary that the property was acquired as an integral part of a bona fide plan to solve serious financial difficulties of the business.

(d) Disposition of Business Assets Following a Change in Control.—

(1) General Rule.—If, within 5 post-change taxable years, a loss corporation (or its successor in a reorganization or liquidation to which section 332 applies), sells or otherwise disposes of any business asset (other than inventory sold in the ordinary course of business) owned by the corporation at the date of the change in control, the entire amount realized will decrease unused acquisition value as of the first day of the taxable year. If such amount exceeds such unused acquisition value, the excess shall be ordinary income to the loss corporation or its successor to the extent of acquisition value absorbed in prior taxable years. Except for section 47 (dealing with recapture of investment credit), no other or additional gain or loss will be recognized to the loss corporation or its successor on a disposition to which this paragraph applies.

(2) Amount Realized.—For purposes of paragraph (1), the amount realized shall be:

(A) In the case of a sale or exchange, the amount of money plus the fair market value of other property received;

(B) In the case of any distribution to shareholders (including redemptions and distributions to which section 301 applies), the fair market value of the business assets distributed.

(3) Exceptions.—

(A) Reorganizations; Section 332.—If substantially all the assets of the loss corporation are transferred to another corporation in a reorganization described in section 368(a)(1) or in a liquidation to which section 332 applies, paragraph (1) shall not apply to the transfer, but will apply to later dispositions by the transferee.

(B) Other nonrecognition transactions.—Paragraph (1) shall not apply to a sale or other disposition in which gain or loss is not recognized in whole or in part.

(C) Purchase of assets in same business.—Paragraph (1) shall not apply if, within 6 months after the date of sale or other disposition, the corporation purchases, for an amount not less than the sale price, other assets for use in the same trade or business as that in which the assets sold or otherwise disposed of were used.

(e) Operating Rules.—

(1) Absorption of Carryovers.—In each post-change taxable year, net operating loss, capital loss, and credit carryovers from pre-change taxable years shall be absorbed, to the extent there is sufficient unused acquisition value, in the sequence elected by the taxpayer or, in the absence of such an election, in the sequence and manner prescribed by regulations adopted by the Secretary. In applying the preceding sentence, capital loss carryovers to a post-change taxable year may offset capital gains in an amount not greater than 5/3 of unused acquisition value, and tax credit carryovers may be utilized in a post-change taxable year in an amount not greater than 1/2 the amount of unused acquisition value.

(2) Unused Acquisition Value.—The term "unsused acquisition value" means the excess of acquisition value over—

(A) The amount of net operating loss carryovers to which subsection (a) applies and which has been deducted in prior post-change taxable years;

(B) 3/5 of the amount of capital loss carryovers to which subsection (a) applies and which were used to offset capital gains in prior post-change taxable years; and

(C) Two times the amount of any credit carryovers used in reduction of tax in prior post-change taxable years.

(3) Constructive Ownership.—For purposes of subsection (b), the rules applicable in determining ownership of stock under section 341(d)(1) (relating to collapsible corporations) shall apply in determining changes in control.

(4) Definition of Stock.—For purposes of subsection (b), the term "stock" does not include stock which is:

(A) Not entitled to vote,

(B) Fixed and preferred as to dividends and not entitled to participate in the distribution of earnings in excess of such dividends, and

(C) Not convertible into stock which fails to meet the requirement of (A) or (B).

(f) Special Rules.—For purposes of this section—

(1) Multiple Classes of Stock.—Where more than one class of stock is outstanding, acquisition value will be determined under regulations prescribed by the Secretary, taking into account the relative fair market value, the relative voting power and the relative degree of participation in earnings of each class of outstanding stock.

(2) Stock Acquired for Property; Contributions to Capital.—Where stock of a loss corporation is issued in exchange for property other than money, the price paid by the acquirer will be deemed equal to the fair market value of the property transferred to the corporation. Any transfer of money or other property to a loss corporation as a contribution to capital shall be treated as an exchange of such money or other property for stock of the corporation equal in value to the fair market value of the money or other property transferred.

(3) Series of Transactions.—If a change in control described in subsection (b)(1)(A) is followed, within the succeeding 36 months, by a reorganization to which subsection (b)(1)(B) applies, and to which the person or persons who obtained control are a party, this section shall not apply to the reorganization. If stock acquisitions not resulting in a change in control occur within 36 months before the date of a reorganization to which subsection (b)(1)(B) applies, acquisition value shall be determined by an average price per share under regulations which shall follow the method set forth in subsection (c)(1)(A). Where stock purchases or other stock acquisitions by an acquiring corporation precede, by more than 36 months, a reorganization to which subsection (b)(1)(B) applies, or where nonexchanging shareholders remain after a reorganization described in section 368(a)(1)(B), acquisition value shall be determined by grossing up the consideration issued in the reorganization, under regulations prescribed by the Secretary applying a method similar to the method set forth in subsection (c)(1)(A).

(4) Successive Transactions.—Notwithstanding the provisions of subsection (c), if the limitation under subsection (a) has once been imposed on a carryover, and if another change in control occurs at a later date, the acquisition value arising upon the later change in control shall not exceed the unused acquisition value as of the end of the taxable year immediately preceding the later change in control.

TECHNICAL EXPLANATION OF THE PROPOSAL

The basic idea is to allow loss and credit carryovers to survive a change in stock control of a loss company to the extent the loss company could reasonably have expected to have used its own carryovers if there had been no change in its ownership and control. This result is achieved by allowing the carryovers to survive in reasonable proportion to the present value of the future income stream likely to be produced by business assets of the loss company. As a result, tax attributes will be available to a new owner only as an incident to a transaction in which the acquirer pays primarily for income-producing business assets of the loss company.

General Rules

Net Operating Loss Carryovers. If a corporation having loss carryovers ("loss company") undergoes a change in control of the ownership of its stock, the company (or its successor in the case of a reorganization) will be allowed to deduct net operating loss carryovers up to (and not in excess of) its acquisition value at the time of the transaction.

Capital Loss and Credit Carryovers. Capital loss carryovers following a change in control can offset capital gains the extent of 5/3 of the acquisition value.[1] Tax credit carryovers will survive a change in control in an amount equal to 50 percent of acquisition value.

Basic Definitions

Change in Control. Where a loss company engages in a tax-free reorganization, a change in control occurs if the shareholders of the company (immediately before the transaction) own, immediately afterward, less than 50 percent of the total voting power or of the fair market value of all outstanding stock of the surviving company (including a controlling parent, in the case of a triangular reorganization).

Where shareholders of a loss company sell some or all of their shares in a taxable transaction, or the company issues new shares in exchange for money or property (including a section 351 transaction and a recapitalization under section 368(a)(1)(E)), or the company repurchases some of its outstanding stock, a change in control occurs if five percent or larger shareholders own, on the last day of the taxable year, a percentage of the fair market value or voting power of total outstanding stock which is at least 50 percentage points greater than the same percentage owned by the same persons at the beginning of that year, or at the beginning of the first or second preceding years. Since the rule for purchases and new stock issues is based on an increase in the recipient's percentage point interest, this rule will not count an existing shareholder's "old and cold" stock but will apply only if his existing interest increases by 50 percentage points or more thereafter.

Exceptions. Certain changes in the stock ownership of a loss company are excepted from these limitations. Exceptions are made for:

(a) acquisitions of stock by small (under five percent) shareholders;
(b) gifts of stock or transfers upon death;
(c) transfers of stock between related persons, or in a divorce or marital separation;
(d) stock acquired by key employees, employee stock ownership plans or qualified employee trusts. A key employee is defined as a person employed full time by the company continuously for at least five years;
(e) a redemption of stock to pay estate taxes;
(f) acquisitions of stock by creditors of the company in exchange for their claims. The claim must not have been acquired by the creditor for the purpose of obtaining the stock, and the stock must be received under a plan for rehabilitating a financially troubled business in which holders of a majority of creditor claims, by number and dollar amount of claims, participate. The loss company does not have to be in a formal bankruptcy.
(g) certain reorganizations of financially troubled savings and loan associations.

Changes in the ownership of certain kinds of stock are also excepted. Stock will not be affected by the proposal if it is not entitled to vote, carries fixed and preferred dividend rights (and is not entitled to participate in earnings in excess of those rights), and is not convertible into voting stock or stock which participates in earnings or carries a nonfixed or nonpreferred dividend right.

Acquisition Value. Acquisition value will be determined by reference to the consideration issued in the transaction, and will be subject to certain subtractions.

"Unadjusted" Acquisition Value. Where a single class of stock is outstanding and a change in control results from a purchase of stock from existing shareholders, a new issue of stock by the company, a redemption, or any combination of these transactions during any three consecutive taxable years, the acquisition value of all outstanding stock will be the purchase price paid for the stock which changes hands. (A note, stock, or other property paid as part of the purchase price will be taken into account at fair market value.) If less than all the stock changes hands, the company's total value will be determined by "grossing up" the price paid for the shares which were purchased, newly issued or redeemed. For example, if a new investor buys 5,100 of 10,000 outstanding shares of loss company L for $510,000, the price paid per share is $100 ($510,000 divided by 5,100). This amount ($100) is then multiplied by the total number of outstanding shares after the transaction (10,000) to produce the acquisition value of the loss company, $1 million. If a new investor contributes money or property directly to L in exchange for newly issued shares of L constituting 50 percent or more of L's total outstanding stock, acquisition value will be the value of the company before the infusion of new capital. For example, if L has 10,000 outstanding shares and a new investor contributes $20,000 for 40,000 new shares, the acquisition value of the company is $5,000. This is determined by first computing a price per share to the new investor (50 cents), then multiplying that price by total outstanding shares (50,000) and subtracting the new capital ($20,000). A redemption of outstanding shares reduces, rather than expands, the pool of capital inside a loss company. Accordingly, in a redemption, acquisition value will equal the value of the unredeemed shares immediately after the redemption, based on the per share price paid by the company for the repurchased shares.

Where new stock is issued for property other than money, the value of the stock received will be deemed equal to the fair market value of the property transferred in exchange for the stock. It is immaterial under this rule whether the issuance of new shares is taxable to the transferors or is tax-free under section 351 or under the recapitalization rule of section 368. This rule also applies where a loss company buys profit-generating assets for its own newly issued stock in a transaction taxable to the seller.

Where the stock or assets of a loss company are acquired by another company in a tax-free reorganization, the acquisition value of the loss company will be equal to the fair market value of the stock received by shareholders of the loss company, plus the amount of money and the value of other property, if any.[2]

Where stock purchases or other stock acquisitions precede a tax-free reorganization within three taxable years, acquisition value will be determined by a grossing up a unit price per share under regulations to be prescribed by the Secretary. Where stock purchases or other stock acquisitions by the acquirer precede a tax-free reorganization by more than three years (old and cold stock), or where a minority of nonexchanging loss shareholders remains after a "B" type acquisition of less than 100 percent of a loss company's stock, the value of the stock issued in the reorganization will be "grossed up" under similar procedures.

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[1] Ordinarily, a capital loss carryover offsets a capital gain dollar for dollar. However, the tax benefit from a capital loss is 60 percent of the tax benefit from a net operating loss. If the remaining unused acquisition value in the current year, e.g., $600, is less than the unused capital loss carryovers (e.g., $1,000), proper use of capital loss carryovers can be reflected by grossing up the acquisition value by 5/3 to $1,000, with the result that the entire $1,000 capital loss carryover can be deducted in the current year.

[2] If the loss company acquires the profit company, acquisition value will be the value of the combined company's stock retained by shareholders of the loss company. The gross-up calculation for determining acquisition value will be used for this purpose.

Modifications. Once unadjusted acquisition value is determined, subtractions are required in order to prevent an artificial purchase price or transactions in which assets of a loss company are artificially inflated before a sale takes place. Acquisition value is therefore reduced by:

(a) cash (plus net receivables) owned by the loss company immediately before the transaction;
(b) investment assets (stocks, bonds, real estate, etc.) owned by the loss company at the date of sale; and
(c) business assets transferred into the company within 24 months before the date of sale as a contribution to capital or in exchange for stock.

The subtraction in (b) or (c) will not be made if the taxpayer can show, to the satisfaction of the Secretary, that the property was acquired as part of bona fide effort to rehabilitate an otherwise financially troubled business.

Operating Rules

Absorption of Carryovers. The sequence in which different types of carryovers (net operating loss carryovers, tax credit carryovers and capital loss carryovers) will absorb total acquisition value may be elected by the taxpayer. Once made, this election will be irrevocable unless the Secretary consents to a change in the sequence for prior years. If the taxpayer fails to make an election, the Internal Revenue Service will specify by regulation how different types of carryover will reduce acquisition value. Carryovers to each post-change taxable year will be deductible to the extent sufficient unused acquisition value remains at the end of the immediately preceding year. Unused acquisition value is the original acquisition value, reduced by:

(a) net operating loss carryovers from pre-change taxable years deducted in one or more prior taxable years following the change in control;
(b) 3/5 of the capital loss carryovers from pre-change taxable years used to offset capital gains in one or more prior post-change years; and
(c) two times the amount of any tax credit carryover used to reduce tax in one or more prior post-change years.[3]

Contributions to Capital. A transfer of money or other property directly to a loss company as a contribution to capital will be treated as an exchange of the money or property for stock having a value equal to the amount of money plus the fair market value of the other property.

Series of Transactions. Several rules deal with two-step or multiple step acquisition formats which are often used by one company to acquire another. If a profit company, P, purchases by tender offer 51 percent or more of the stock of a loss company, L, and, within 36 months after the last day of the year in which the final purchase is made, L merges with P, the limitation on carryovers from years before the change in control will be determined solely by reference to the stock purchase price on the first step. The price paid to purchase 50 percent or more of L's stock will be grossed up to determine acquisition value, and the value so determined (with subtractions) will determine the ceiling on carryovers from pre-change taxable years without regard to the merger. If P acquires L's assets by merger more than 36 months after P purchased 51 percent of L's stock, carryovers will be based on the grossed up purchase price in post-purchase taxable years until the merger. Thereafter, carryovers from years before the purchase of control and carryovers, if any, incurred in years after the purchase of control and up to the merger, will be limited by grossing up the fair market value of the stock issued in the merger.

If P purchases 80 percent or more of L's stock and makes an election under section 338, L's carryovers disappear entirely because the election means that the transaction will be treated as a taxable sale and purchase of L's assets (section 338(a)(1)). If P does not make an election in this situation, the purchase price rule will determine how much of L's carryovers survive the change in control.[4]

If P buys less than 50 percent of L's stock and within 36 months merges L with P, acquisition value will be based on a per share purchase price derived from the total consideration paid by P in both steps. If the merger in this situation occurs more than 36 months later, acquisition value will be determined solely by grossing up the fair market value of the stock issued in the merger.

If P buys control of L stock and shortly afterward merges L with S, a controlled subsidiary of P, L's carryovers will be limited to the stock purchase price and no further limitation will be imposed on account of the merger. If the merger fails to qualify as a reorganization and the entire transaction can be recast as a taxable sale of assets by L to S, no carryovers at all may survive. If P purchased L stock long ago, so that its ownership is now "old and cold," and P causes L to merge with S, L's carryovers from before P's purchase will be available to S in the amount of P's original purchase price. The merger will not trigger a new limitation because L's shareholder, P, continued to own more than 50 percent of the stock of the acquiring company, S, after the merger.[5]

Successive Transactions. Where control of a loss company changes through successive new owners, each owner can obtain for the company no more of the carryovers from years before the first change in control than remained to the preceding owner. Thus, if L, a loss company, has $10 million loss carryovers and shareholder A sells all of the stock to new owner B for $1 million, $1 million of the carryovers survive. Assume that $550,000 of those carryovers are used during B's ownership. B then sells all the stock to C. The company could not use more than $450,000 of carryovers remaining under the original limitation, regardless of the amount of C's purchase price. Any losses incurred during B's ownership, however, could carry over to C up to the amount of C's purchase price (after subtracting $450,000 of old, limited carryovers).

Sales of Business Assets Following a Change in Control

If, within five years after a change in control, the loss company or its successor disposes of any business asset (other than inventory sold in the ordinary course of business) owned by the loss company at the time of the change in control, the entire amount realized will decrease acquisition value. If the amount realized exceeds the remaining unused acquisition value, the excess will be ordinary income to the loss company (or its successor) to the extent of acquisition value previously absorbed. Except for investment credit recapture, no other or additional gain or loss will be recognized to the loss company or its successor. If the assets of the loss company or its successors are transferred to another company in a tax-free reorganization or in a section 332 liquidation, the general rule will not apply to the transfer, but will apply to later dispositions by the transferee.

Related Matters

Role of Section 269. The anti-tax avoidance rules of section 269 will not apply to any carryover of net operating losses, capital losses, or unused tax credits. The statute will be expressly amended to so state.

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[3] To illustrate with the example in footnote 1, in order to determine the effect of the available capital loss carryover in the current year on acquisition value remaining for future years, acquisition value at the beginning of the current year is reduced by 3/5 of the capital loss carryover used in the current year. Since $1,000 of the capital loss carryover was used in the current year, acquisition value remaining to be absorbed in future years is reduced by 3/5 of $1,000, or $600. Hence, on these facts, no more carryovers of any kind from pre-change years may be deducted.

[4] A complete liquidation of L into P will not reduce the carryovers further, and the remaining amount of acquisition value will be available against P's income, provided the liquidation occurs outside the consistency period of section 338(f).

[5] This more-than-50 percent threshold rule would replace the existing common ownership rule in present section 382(b)(3).

Spin-offs and Other Corporate Divisions. The Secretary will be given authority to adopt rules for allocating loss and credit carryovers after a corporate division (including a spin-off, split-off or split-up).

Consolidated Returns. If a consolidated return group buys the stock of a loss company, the question arises as to the income of which member of the group the carryover is deductible against (up to the acquisition value of the new member). The question is whether the separate return limitation year rule (SRLY) of Reg. §1.1502-21(c) and the consolidated return change of ownership rule (CRCO) of Reg. §1.1502-21(d) are still needed. These decisions involve consolidated return policy and should be reflected by amendment to the consolidated return regulations.

IRS NEWS

IRS EXTENDS COMMENT PERIOD ON WAYS TO FILE COMPUTER-PREPARED TAX RETURNS. *The Internal Revenue Service issued the following news release on September 1, 1983 as IR-83-110:*

WASHINGTON, D.C.—With the number of computer-prepared tax returns growing rapidly, the Internal Revenue Service today said that it is seeking public comment on whether to consider proposals to allow filing in machine-readable form.

Noting that over 10 million individual returns were prepared by computers in 1982, the IRS said that because these returns are sent in as paper documents, each must be converted into machine language for processing by the IRS computer system.

It would substantially reduce IRS processing costs if the information on computer-prepared returns was converted to machine language without transcription. Therefore, the Service has proposed two methods under which tax returns would be filed—either on magnetic media or on standardized paper documents readable by optical character recognition machines. The IRS emphasized that there will be no immediate change in filing procedures and it is not anticipated that changes would be implemented before tax year 1984.

In deciding whether to implement either or both of these methods, the IRS said it is inviting written comments from taxpayers and return preparers. Comments should indicate the preferred method, the number of returns a preparer would expect to file, the time needed for implementation and any benefits to the preparer or taxpayer.

The IRS published a detailed announcement concerning the proposal in the March 29, 1983, Federal Register (Vol. 48, No. 61), pages 13131-13135. The announcement asked for comments by May 13, 1983, but the IRS said today that comments will be accepted through September 30, 1983.

The full text of the IRS news release has been placed in the September 12, 1983 Tax Notes Microfiche Data Base as Doc 83-8021.

IRS RECOMMENDS $1.5 MILLION ASSESSMENT AGAINST LIFE SCIENCE CHURCH MEMBERS. *The Internal Revenue Service issued the following news release on September 9, 1983 as IR-83-111:*

WASHINGTON, D.C.—An Internal Revenue Service task force in New England has recommended the assessment of $1.5 million in taxes due from 81 illegal tax protesters, the IRS announced today.

The protesters, all members of the Life Science Church, agreed to pay all back taxes, interest and applicable penalties. The 81 were among 91 Life Science Church members under investigation by the task force, the IRS added.

According to the IRS, some of the protesters became disenchanted following the conviction and jailing of William Drexler, the founder of the Life Science Church. The protesters contacted an accountant and asked for advice on how to resolve their tax problems. The accountant then agreed to contact the IRS.

The Life Science Church sold mail-order ministries to individuals, claiming that they could avoid federal income tax by forming a church, taking a vow of poverty and donating their assets to the "church." The church then would pay the personal expenses of the mail-order minister. The IRS said the New England protesters apparently believed these claims.

In 1982 a California jury found Drexler guilty of 26 criminal tax violations, including conspiracy to help others evade tax. Testimony at his trial showed that Drexler sold church credentials for $560 to $4,000 each. He was sentenced in January of 1982 to five years in prison, five years probation and a $50,000 fine.

Contributions to organizations operating exclusively for religious purposes are deductible under the law. However, the IRS explained, the mere holding of a church charter and claiming to be a church do not prove that an organization operates for religious purposes.

In order for contributions to be deductible, the organization must not only be organized and operated exclusively for religious purposes, but it must also have operations that further religious purposes, according to the IRS.

The Tax Court of the United States has ruled in numerous cases that mail-order churches exist for the economic benefit of the founder and not exclusively for religious purposes. Since the contributions inure to the benefit of the contributor, no deduction can be allowed under the law for a charitable contribution, the IRS said.

The full text of the IRS news release has been placed in the September 12, 1983 Tax Notes Microfiche Data Base as Doc 83-8025.

THREE ADDITIONAL FEDERAL INCOME TAX FORMS RELEASED. The IRS recently released the following three 1983 federal income tax forms:

- Instructions for Form 1096, (**Annual Summary and Transmittal of U.S. Information Returns**) and Forms 1099-ASC, 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, 5498, and Nominee Returns. *Doc 83-7990*
- Form 1099R, **Statement for Recipients of Total Distributions from Profit-Sharing, Retirement Plans and Individual Retirement Arrangements.** *Doc 83-7991*
- Form 6627, **Environmental Taxes.** *Doc 83-7992*

These forms have been placed in the September 5, 1983 *Tax Notes Microfiche Data Base.*

Mr. DORGAN. Thank you very much.

Mr. Ellingson.

STATEMENT OF JOHN F. ELLINGSON, ESQ., GARVEY, SCHUBERT, ADAMS & BARER, SEATTLE, WASH.

Mr. ELLINGSON. Mr. Chairman, I appear today in my individual capacity. In 1979 I chaired an ABA Young Lawyer Division Subcommittee on Tax Treatment in Bankruptcy. In that capacity, I had the opportunity to work with Mr. Bacon during the drafting and adoption of the Bankruptcy Tax Act back in 1980.

Since that time, my practice as an attorney has been predominately devoted to counseling companies and others who are looking to rehabilitate troubled and nearly bankrupt companies. As I am sure the subcommittee is well aware, there has been a substantial increase over the last several years in the number of domestic companies that have filed bankruptcy petitions. Several industries have been devastated by the recent economic conditions.

I would depart somewhat from the previous testimony today, and not address so much the technical aspects of the press release proposal, but address the request that accompanied the press release to deal with some of the practical applications of the proposal. I would limit my comments in that respect to its application to a financially distressed or bankrupt company and its creditors.

The proposal seems, in my mind, to be contrary to the application of the Bankruptcy Code and contrary to what was attempted under the Bankruptcy Tax Act of 1980, both in the treatment of creditors and in the treatment of a debtor or loss company.

One must recognize the situation that the bankrupt company is in: it has no equity left for shareholders. Once it has filed bankruptcy, it is by definition 100 percent debt financed. A company that survives bankruptcy, and is successful in rehabilitating itself, typically sees the rights of the historic shareholders extinguished.

The principle of the *Alabama Asphaltic* case seems to apply here in that the creditors become the actual owners of the company. The problem with the proposal before the committee is its treatment of stock issued to these creditors. The proposal assumes a pro rata distribution of that stock. The structure of bankruptcy does not always allow for a pro rata distribution.

Bankruptcy requires that creditors be treated in classes with differing rights and priorities. They are treated pro rata only within those classes. I think to the extent that this proposal, or even section 382 as it exists, deals with that, it doesn't recognize that situation.

The Bankruptcy Tax Act of 1980 created a rule that requires tax attributes, including net operating losses, to be reduced to the extent that debt forgiveness occurs as a result of the bankruptcy.

To further reduce those tax attributes in the manner contemplated by the proposal, in my mind and in my experience, would certainly produce a chilling effect on the rehabilitation of the debtor. The net result, in fact, if you look at an example that I am about to give you, would be a negative effect on the Federal fisc.

The reduction of tax attributes in a bankruptcy situation gives rise to a corresponding bad debt deduction for the creditors. Both the net operating loss and the bad debt deductions are deductions against gross income at ordinary rates. So you have a one-for-one exchange. To repeat, if you extinguish the net operating loss in the loss company in bankruptcy, you create an equivalent bad debt deduction in the creditors.

If you allow those net operating losses to carryover under the rule that was promulgated by the Bankruptcy Tax Act, you will create income in a distribution to the creditors to the extent that they get cash, or that they get stock and ultimately dispose of the stock which would be taxed at ordinary rates subject to ordinary deductions. In that case, by allowing the carryovers, you would in fact create ordinary income at the creditor level.

I would endorse the concern and position of the Treasury stated earlier today concerning the ability of a troubled company to go to the debt market for further financing. Such a scenario is essentially impossible. The problem that exists with almost every company is that they have gone too far into that market. To penalize that company at this point in its life, by denying it access to an equity market, seems to me to be counter to the stated position of the subcommittee in hoping to rehabilitate the economy.

I would also like to address the situation regarding trafficking in losses, and suggest that I think there is much more about it than actual trafficking. I am in a situation in my practice where I have a number of clients who come to me looking for companies to acquire that may be in bankruptcy. These clients feel that there may be a bargain element in such a setting and they may be able to strike a particularly good deal.

Probably the last thing they look at and the last thing they ask me about are the tax attributes of that company. If you get to a situation where the company has no assets other than its tax attributes, the risk-taking analysis that acquirors go through discounts that substantially, and they would not in most cases look at that sort of company unless it were a business that they could understand and could run, and there were something there to get.

I would bring up the situation of Braniff Airlines. Certainly Braniff doesn't own many of their airplanes. It is the creditors that own the airplanes and there may be nothing else left there. However, if you can recover a route structure, if you can recover landing rights, if you can recover something that would allow you, in a very short period of time—Braniff announced the other day that it will be flying in January—to bring up a major enterprise, it would be easier than starting afresh. Although there are no tangible assets that you might buy, other than from the creditors, it makes some sense in such a situation to rehabilitate the debtor.

However, to acquire a company that is merely a shell because it has some losses, for a company that has an otherwise unblemished record doesn't want to buy the litigation; and doesn't want to buy the situation of a long audit process.

I am sure there is some trafficking in losses, and I think we would be naive to say that there isn't. Certainly section 382 as it exists now does have some room for abuse available to be utilized. However, I would like to suggest to the subcommittee that to draft to simply avoid abuses in an overbroad manner certainly skews the neutral approach that a tax policy ought to have. I think that it is very important that the tax policy be neutral, that it not try to induce one transaction in favor of another.

Thank you.

[The prepared statement follows:]

Statement of John F. Ellingson of Garvey, Schubert, Adams & Barer, Seattle, Wash.

I. SUMMARY OF POINTS

1. 1. Proposal is not consistent with previously stated policy of Congress on the treatment of debtor corporations and creditors who are parties to corporate reorganizations.
2. Proposal is inconsistent with Congressional policy as expressed in the Bankruptcy Code.
3. Proposal is overly simplistic and not responsive to economic reality.
4. A viable alternative to the proposal exists.

II. INTRODUCTION

Mr. Chairman and members of the committee, rather than address all of the provisions of the proposal before the committee, I will limit this testimony to the following subject areas:

A. The merger rule.
B. New stock issues.
C. General rules.
D. Proposed remedy.

III. DISCUSSION

A. The Merger Rule

Policy difficulties exist with the proposal before the committee, in that it runs afoul of previously stated legislative goals of Congress. In the Report of the Committee on Ways and Means on the Bankruptcy Tax Act of 1980, this committee stated its reasons for adding the "G" reorganization provision to the Internal Revenue Code:

". . . [T]o facilitate the rehabilitation of corporate debtors in bankruptcy, etc., these provisions are designed to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of the present law. To achieve this purpose, the new 'G' reorganization provision does not require compliance with State merger laws (as in category 'A' reorganizations), does not require that the financially distressed corporation receive solely stock of the acquiring corporation in exchange for its assets (category 'C'), and does not require that the former shareholders of the financially distressed corporation control the corporation which receives the assets (category 'D')." (House Report No. 96–033, p. 30.)

Senator Dole, in explaining the provisions of the Bankruptcy Tax Act of 1980 on the floor of the Senate, stated:

"[T]he Bankruptcy Tax Act is the product of years of effort and addresses the needs and interests of debtors, creditors, and bankruptcy practitioners alike.* * *

"* * * The Finance Committee, however, was concerned that the legislation as referred to the committee was not balanced sufficiently to allow debtors to reorganize and survive economic distress. We, therefore, amended certain rules relating to the exchange of debt for stock of the debtor. Under the committee amendment, a corporation will neither recognize income, *nor will [it] be required to reduce tax attributes such as net operating loss carryovers* when it issues its stock to a creditor in exchange for outstanding debt.

"This amendment has been strongly supported by practitioners including the tax section of the American Bar Association. We expect that this provision will be very effective in helping financially distressed debtors to regain economic health and keep their employees from losing their jobs." (Congressional Record-Senate, December 13, 1980, S16492–S16493) (emphasis added)

The concerns expressed by Senator Dole are well taken. In my experience as a practitioner utilizing the provisions of the Bankruptcy Tax Act, the survival of tax attributes is often a significant incentive to an outsider who must decide whether or not to invest in the revitalization of a troubled company. To use the value of transferred assets as a measure of the availability of loss carryovers in a manner analogous to contributions of capital to a partnership is not only contrary to existing policy, as expressed above, but fails to recognize that in many cases the asset and book value of a debtor company has been greatly reduced in a short period prior to the filing of the petition in bankruptcy. The depletion of assets comes about in a variety of ways: sales to raise cash, repossessions and foreclosures, other attachments by creditors, etc. To further penalize a company in this position by denying it the full utilization of its prior tax history clearly is salt in its wounds.

Reference to the "shareholders" of the loss company in the proposal does not take into account that the historic shareholders of debtor companies frequently receive nothing under a plan of reorganization in bankruptcy, because shareholders are subordinate to the most junior creditor who must be satisfied in full before any distribution can be made to "shareholders".

Furthermore, if the creditors of a debtor company are viewed as its "shareholders" for purposes of the proposal, the proposal is overly simplistic in that it does not take into account that creditors in bankruptcy proceedings are treated as "classes" rather than aggregated and treated pro rata as a whole.

The final paragraph of the merger provisions of the proposal would look to dividends paid to the loss company "shareholders" who receive preferred stock in a reorganization as a measure of the available loss carryovers, without regard to whether or not these shareholders were holding preferred shares prior to the reorganization. Such treatment is simplistically naive and does not respond to reality.

B. New stock issues

Consider the case of a new corporation that is developing a product for market. The company adopts a business plan that contemplates the following: The initial engineering stage is funded by a mixture of debt and equity either personally guaranteed by the founders or contributed directly by them. At this stage the company is capitalized at $500,000. The following year the company appeals to the friends and relatives of the founders, and through a private offering it increases its capital base by $5,000,000 to build a plant, start production, and begin testing and marketing the product. To accomplish the second step the founders have to dilute their interest to less than 20 percent. After establishing a track record in limited markets, the company goes public with a $40,000,000 public sale of its stock. Again, the previous shareholders are diluted to less than 20 percent of their previous position. At no time do any of the existing shareholders acquire any of the new issues. At each stage in the growth of this company, the shares held before the expansion significantly increase in value immediately following the infusion of new capital because of the success of the venture.

If the provisions of the proposal are applied to this scenario, all of the startup, tooling, and initial costs and production depreciation (which would be loss carry forwards) will be lost by the company before its well-planned efforts can produce significant profits. Such a result certainly would inhibit the formation of capital and hinder such a venture.

B. General rules

The treatment of creditors who exchange debt for stock does not comport with the structure of the Bankruptcy Code. The proposal suggests that, if creditors receive stock for their debt in a bankruptcy setting, there should be no reduction of the loss carryforward if such stock is received on a pro rata basis. The language requiring "pro rata" treatment will prove problematic in bankruptcy, where historic shareholders frequently have their interests extinguished, and creditors share pro rata only within their respective classes. This portion of the proposal should be completely redrafted to take into account statutory bankruptcy procedures and the economic reality of this situation.

Furthermore the Committee should be aware that the likelihood of creditors' coming to the rescue of a debtor is more the exception than the rule. Seattle Bankruptcy Judge, the Honorable Kenneth S. Treadwell, was quoted in the Seattle Post-Intelligencer, Monday, June 28, 1982 as follows:

"[T]he law [the Bankruptcy Code] was written by law professors, attorneys and bankers familiar with the problems of the big corporation. It assumes that the bankrupt company will hire a skilled bankruptcy specialist and that the creditors will get involved. . . . [This happens] in about 5 percent of the cases."

D. Proposed remedy

Consider the following situations:

Situation 1: The startup manufacturing business outlined above.

Situation 2: A taxpayer inherits a sum of money and invests it in a corporation to manufacture widgets. The taxpayer discovers that he is ill prepared to conduct such business. Over a period of several years, he loses half of his investment. The taxpayer then properly concludes that he is far better prepared for the manufacture of gizmos and proceeds to sell off specialized assets of his company and converts to the manufacture of gizmos. The manufacture of gizmos becomes a profitable business for the taxpayer.

Situation 3: The taxpayer's twin receives a similar inheritance, invests it in the widget business, and, after following the identical path, loses half of his investment. However, rather than converting the business to the manufacture of gizmos, the twin closes up shop and converts the assets to cash. He then spends six months casting about for something to do and ultimately uses the cash to purchase a gizmo manufacturing company.

Situation 4: A giant railroad corporation is established in 1890. By 1983 it has had to complete turnovers of its shareholders.

Situation 5: Acme Framus Corporation is a 30-year old company that has been continuously involved in the manufacture of framuses. For the last ten years, Acme has steadily lost money. Instant High-Tech Corporation offers $10,000 to Acme's shareholders for all of their shares, and the offer is accepted. Upon acquiring Acme-Framus, Instant High-Tech immediately stops manufacturing framuses and starts manufacturing digital watches.

Query: In which of the above situations should the tax history of the predecessor business survive and in which situations should it be extinguished?

In Situation 3 (the twin who abandons his business to start fresh in a different industry), the tax history of the predecessor business should be extinguished. In Situation 5 (the takeover in which the business is converted from the manufacture of framuses to the manufacture of digital watches), the tax history should also be extinguished. In all of the other situations, it is logical to have the tax history of the business survive unchanged.

Query: What is the rule that should be applied to these situations?

In examining these situations, it is clear that a mere change in the number and/or composition of the shareholders should not cause the tax history to disappear. It should also be clear that a change in the business in and of itself should not work this result. However, where both occur, either over a short period of time or as part of a single plan, the tax history of the business should be extinguished. This is basically the philosophy of IRC Section 382(a).

Any proposal that would improve upon Section 382 as amended but as yet not effective will have to address the criticisms that have been leveled at these amendments. The premise of the amendments is sound. However, the application of the amendments would be most cumbersome.

I would propose the following two-pronged alternative:

1. Section 382(a), as amended but not yet effective, would be adopted as a safe harbor provision. The tax history would survive in any transaction where the specific requirements of this Section were met.

2. A second subjective test would also be adopted. Under this test, the tax history of a taxpayer would survive in any transaction where there was not both (a) a material change in shareholders, and (b) a material change in the conduct of its business.

The safe harbor provision of the proposal would provide practitioners and taxpayers certainty as to their position if they met the specific criteria of the statute.

The alternative provision would be based on a facts and circumstances test, using the concept of "materiality" as developed under federal securities law. This materiality test has fifty years of common law behind it. While there has been much litigation surrounding this issue, neither Congress nor the business community has sought any significant change in this area.

The proposed two-pronged approach would allow those taxpayers seeking absolute certainty the safe harbor provisions of Section 382. Those taxpayers who were willing to assume a business risk in a situation that did not meet the safe harbor provision, but which they felt was not abusive, could take their chances on the facts and circumstances test. Adopting the materiality test would still give the taxpayer and the taxpayer's advisor a body of settled law to guide them in their planning.

As the Committee is well aware, purely mechanical tests will always deny a certain number of non-abusive situations the legitimate treatment they should receive. Therefore, a rule that provides both for a mechanical safe harbor test and a more flexible but well-settled common law test meets the needs of government and taxpayers for certainty and provides for proper treatment of the non-abusive situation that is unable to fit into the narrow confines of a mechanical determination.

The Committee should be aware that the resolution of problems in the abstract without reference to reality produces neat results only in the abstract and does not address real problems.

I would respectfully urge the Committee to carefully consider the alternate proposal set forth above. However, if the Committee proceeds under its current proposal, I would urge the members to undertake a conscientious effort to conform its proposal to the policy and procedures under the Bankruptcy Tax Act of 1980 and the Bankruptcy Code.

Mr. DORGAN. Let me ask Mr. Bacon, and then I would like to ask all of you a question.

Mr. Bacon, you proposed a solution which you said is simple. I am always suspicious of lawyers who talk about simplicity, but your solution did sound simple to me. It seems to me that your solution is contrary to what Mr. Tomasulo had suggested.

Your suggestion apparently embodies the principle that a loss should survive even though all of the physical assets may be gone. Is that true?

Mr. BACON. No; Nicholas and I wrote this article together. He was addressing the question of whether the purchase price ought to be the measuring rod or the yardstick for losses without regard to whether the company has active or passive assets. My position on that is the same as Mr. Tomasulo's. That is, you would and you should, to prevent abuse, eliminate liquid assets, so that if the purchase price were $500,000—I think I gave that example—the losses as a general rule would be limited to $500,000 less passive assets and liquid assets that are in the loss company. Obviously, if a buyer pays $500,000 for a loss company and there is only $500,000 of cash in it, he is essentially buying a company with losses for nothing.

You have a sliding scale from pure cash down through all kinds of investments which are liquid in different degrees and passive in different degrees. I think we both agree that you must subtract those kind of liquid and passive assets, as well as business assets contributed to the loss company to inflate its value artificially, in order to prevent the grossest kind of abuses.

Mr. DORGAN. You heard the statement that there is more talk about trafficking than there is actual trafficking?

Mr. BACON. I said that this was an intellectual subject, and because of that I do agree. I think lawyers love to talk about this, because it gets to the essence of taxation. Yes, I think there is more talk about it than actual abuses.

This subject today is not like safe harbor leasing where you have some visible abuses in the newspapers or that are staring you in the face, and you must go to the window and say, I won't take this anymore. We don't have that as seriously in this loss carryover area. If there are some abuses that occur, they have been around for 30 years, and in any case we should not rush to adopt any old rule before we carefully consider the best alternative for changing the law.

Mr. DORGAN. But don't you agree that the passage of ACRS in the 1981 Act certainly heightened the prospect for abuse.

Mr. BACON. Yes; I do.

Mr. TOMASULO. Yes, very much.

Mr. **Bacon**. I agree. I think the purchase price rule as well as the income rule will prevent abuses of tax motivated mergers, as they are called.

Mr. **Tomasulo**. I would like to say one thing. No matter what approach you use, whether you take the purchase price or the income return on the purchase price, the ALI or the staff approach, you must face the question of what your base is going to be.

In other words, are you going to remove the $100,000 in Treasury notes, are you going to pull that out, on the basis that that represents no business and does not define the corporation in any sense. To that extent, the buyer cannot be getting the same corporation as that which incurred the losses. He is getting $100,000 in cash, in effect, and that is critical in any one of these approaches.

If you want to make the statute generous, as Mr. Bacon has said, you can increase the base from 100 percent to 110. If you want to make it tighter, reduce the base from 100 percent down to 90. The point about the deduction of the cash is that it is truly functional, it truly tells you to what extent this is the same corporation as it was before, and to what extent it is not. That is, it is really fair.

Mr. **Dorgan**. Mr. Ellingson, is there anything wrong with the proposal that they are making?

Mr. **Ellingson**. No; the concern I have is that the press release, as it was drafted, essentially ignored what is appropriate treatment for creditors. I think that any of the proposals that have been made today are fine, but the people are looking essentially at the solvent situation, they are not looking at the financially distressed company. The statutory overlay of that setting creates some problems for the proposal as it is drafted.

There is one other thing I might point out to the subcommittee in terms of abuses in the situation of a bankrupt company. The bankruptcy court must make a specific finding in the adoption of a plan in bankruptcy that it is not entered into for tax abuse purpose. It must make a similar finding that it is not entered into for any securities fraud. The court examines that in each case, and you have a court determination in each case. So there is additional protection in this area.

The IRS is a party in most cases if the companies have not paid part of their taxes, typically the trust fund taxes rather than the income taxes. The IRS is involved in most cases and does have an opportunity to look at each plan.

Mr. **Dorgan**. In the chairman's opening statement, he pointed out that because of the 1981 act, the ACRS and so on, it is important to move forward and tighten this up. Do you agree that we ought to move with haste here?

Mr. **Tomasulo**. Yes; I think the ACRS increases the pressure on this very greatly.

Mr. **Dorgan**. We have a vote on, and I am going to have to leave. Since there are no other members present, the subcommittee will stand in recess until the vote is over. [Recess.]

Mr. **Guarini**. Gentlemen, if you would be seated, we will begin the testimony of the next panel, Mr. McGrath and Mr. Murphy of the Centel Corp., and Jartran, Inc.

We welcome you and we appreciate the benefit of your thoughts.

Mr. McGrath, you may begin when you are ready.

STATEMENT OF FRANK E. McGRATH, ASSISTANT VICE PRESIDENT FOR TAXES AND RISK MANAGEMENT, CENTEL CORP.

Mr. McGrath. Mr. Chairman, my name is Frank McGrath, and I am assistant vice president for taxes and risk management for Centel Corp. I am testifying today as a representative for Centel.

Centel is a publicly held, diversified telecommunications company with over 50 subsidiary corporations. Headquartered in Chicago, it operates the Nation's fifth largest telephone system, cable television systems in six States, and it is a nationwide provider of business telecommunications systems and materials for the telecommunications industry.

For compelling business, economic, and tax policy reasons, I urge the chairman to reject the proposals being considered today, and to repeal the 1976 amendment to code section 382 in favor of existing section 382.

Centel has been involved in over 40 business acquisitions in the last 5 years, and the decision to acquire a company is never lightly made. It involves numerous considerations. Tax factors and attributes, while a concern, are nevertheless secondary. They generally never motivate nor are fatal to a proposed business combination.

Although trafficking in tax attributes may have existed as an abuse at one time, the simple fact today is that the decision to acquire a business is a multifaceted economic one. Based upon my role in Centel's acquisition program, I can assure the subcommittee that all aspects of an acquisition candidate are reviewed in testing the validity of a purchase price. The perceived abuse of trafficking in losses is, I believe, a myth in today's economic climate.

Mindful, however, of the established congressional policy of curbing tax avoidance acquisitions, I respectfully submit that existing sections 382 and 269 are sufficient deterrents to such trafficking. The proposal before this subcommittee accomplishes no greater end than can be achieved under either existing statute. Lacking a valid tax policy purpose, the present proposal should be rejected as being unnecessary, overly complex, and unworkable.

At first blush, the primary rationale of the proposal appears equitable. However, the rationale contains a shortfall in logic. It examines only ownership changes and not underlying business factors.

The acquiring corporation has, as its starting point, not a new corporation, rather the starting point is a business that labors under a heavy debt load and low productivity. It is incumbent upon Congress to encourage the continued life of struggling businesses and not to penalize by Federal tax law the infusion of needed capital.

The purchase rule under the proposal prevents the new owners of a loss company from enjoying the same use of the carryover items as would have occurred in the absence of a change. The introduction of a new and unwieldy limitation rule is unnecessary in view of the present purchase rule in code section 382.

In addition, the proposal adopts an arbitrary rule for an assumed after-tax yield on assets. It attempts to apply only one objective standard to a subjective concept. Section 334(b)(2) was the codification of objective standards in lieu of judicially imposed subjective standards. These standards were recently found unworkable and ripe for abuse and led to amendment of sections 334 and 341, and the enactment of 338. I caution the subcommittee against adopting similar objective standards again.

The policy behind the proposal's merger rule is similarly misguided. Far from simplifying the existing section 382 rules in a merger, the proposal compounds the problem. Since existing section 382(b) already has a stock ownership test, the proposal for a new statutory table adds needless complexity. The proposal's limitation for the issuance of stock on a non-pro rata basis flies in the face of legislative efforts to simplify the tax law and lacks policy justification.

The general rules of the proposal create endless rounds of computation to determine limitations for all other carryovers. In short, the proposal is a step backward in tax law simplification.

If enacted, the proposal will penalize the loss company by discouraging the continuation of corporate enterprise. Resulting unemployment from the collapse of a business can only mean a lower Federal tax base. This unintended but detrimental consequence must be avoided. The Congress has enacted specific provisions, namely, section 269 and section 382 whose function is to deal with tax avoidance. Additional provisions to serve the same purpose are unnecessary. I urge the members of the subcommittee to reject such redundant measures.

Thank you.

[The prepared statement follows:]

STATEMENT OF FRANK E. MCGRATH, ASSISTANT VICE PRESIDENT—TAXES AND RISK MANAGEMENT, CENTEL CORP., CHICAGO, ILL.

Mr. Chairman and members of this Subcommittee, my name is Frank E. McGrath. I am Assistant Vice President—Taxes and Risk Management for Centel Corporation, and have served in this capacity for approximately 5 years. Prior to joining Centel, I was a Tax Manager with the public accounting firm of Arthur Andersen & Company.

I am testifying today as a representative of Centel Corporation.

Centel Corporation is a publicly-held, diversified telecommunications company with over 50 subsidiary corporations. Centel, headquartered in Chicago, operates the nation's fifth largest telephone system, cable television systems in six states, and is a nationwide provider of business communications systems and materials for the telecommunications industry, and supplies videotex and teletext services.

PROPOSAL REGARDING CARRYOVER OF TAX ATTRIBUTES

In announcing these hearings, the Chairman requested comments on specific proposals which are based upon a recommendation of the American Law Institute. In addition, guidance is being sought on whether to: (1) let amended Code Section 382 enacted in 1976 become effective; (2) extend the effective date again; (3) repeal the rules in favor of existing Section 382; or (4) adopt different rules.

For compelling business, economic and tax policy reasons, which I will discuss, I urge the Chairman and members of the Subcommittee to: reject the current proposal, and repeal the rules enacted under the Tax Reform Act of 1976, in favor of existing Code Section 382.

Centel Corporation has been involved in over 40 business acquisitions in the last five years. The decision to acquire a company is never lightly made and involves numerous considerations.

The acquiring corporation must examine and weigh a company's profit potential, its compatibility with existing businesses and markets, contingent liabilities, shareholder interests, loan agreements and various securities law requirements. Tax factors and attributes, while a concern, are nevertheless secondary. They generally neither motivate, nor are fatal to, a proposed business combination.

Although trafficking in loss carryovers and other attributes may have existed as an abuse at one time, the simple fact today is that the decision to acquire a business is a multifaceted economic decision. With volatile interest rates and rapidly escalating costs of doing business, acquisition tax benefits are only one of many concerns.

Based upon my role in Centel's acquisition program, I can assure the Subcommittee that corporate officers impute a value to all aspects of an acquistion candidate to test the validity of the proposed purchase price. No premium is paid merely for tax attributes. The perceived abuse of trafficking in losses is, I believe, a myth in today's economic climate.

Mindful, however, of the established congressional policy of curbing tax avoidance acquisitions, I respectfully submit that existing Code Sections 382 and 269 are sufficient deterrents to such trafficking. The proposal before this Subcommittee accomplishes no greater end than can be achieved under either existing Code Section. Lacking a valid policy purpose, the present proposal should be rejected as being unnecessary, overly complex and unworkable.

PROVISIONS OF THE PROPOSAL

At first blush, the primary rationale of the proposal appears equitable, i.e., net operating loss carryovers of a corporation should be available to new available to new owners as if no change in ownership had occurred. However, this rationale contains a shortfall in logic. It examines only ownership changes and not underlying business factors.

If the legislative intent is solely to prevent the purchase of tax shelters for expected future profits, this proposal loses track of an important fact. The acquiring corporation has, as its starting point, not a new corporation that can be immediately molded into a profitable enterprise with top management and no history of losses. Rather, the starting point is a business that undoubtedly labors under a heavy debt load, poor management and low productivity. It is incumbent upon Congress to encourage the continued life of struggling businesses, not to penalize by federal tax law the infusion of much-needed capital.

THE PURCHASE RULE

The purchase rule in the proposal prevents the new owners of a loss company from enjoying the same use of the carried over items as would have occurred in the absence of a change in ownership. The introduction of a new and unwieldy limitation rule is unnecessary in view of the present purchase rule of Code Section 382(a). There is no value in requiring a computation that is more complex than presently exists.

In addition to the complexity of the purchase rule, the proposal actually presupposes an abuse that simply does not exist and then penalizes that fictitious abuse. The net result of the proposal is to penalize an acquiring corporation for continuing a loss business. This is contrary to legislative policy. Under existing Code Section 382, the continuation of a business would not be subjected to such limitations. In addition, the proposal adopts an arbitrary rule on an assumed "after-tax yield" of a business' assets. It attempts to apply one objective standard to a subjective concept. Section 334(b)(2) was the codification of objective standards in lieu of judicially imposed subjective standards. These objective standards were found unworkable and perceived as being abused, which led to the recent amendments of Code Sections 334 and 341 and the enactment of Section 338. I would caution the Subcommittee against adopting similar objective standards here.

It is unqualified experience of Centel Corporation that companies are acquired to continue existing businesses. Every question that Centel would ever consider would thus be liable to the new limitation set by the proposal. This additional burden in the already onerous acquisition process could be the straw that breaks the proverbial camel's back.

THE MERGER RULE

The policy behind the proposal's merger rule is similarly misguided. The rationale purports to allow carryovers to the extent they would have been allowable had the parties to the merger formed a partnership. The realities of operating and managing a corporation are vastly different than partnership existence. The sharing of profits and losses has never been an underpinning of the corporate form. Indeed, to attempt to impose on corporate entities the separate and distinct operational rules of partnerships is a serious misapplication of the law.

Far from simplifying existing Code Section 382 rules in a merger situation, the proposal compounds the problem. A new statutory table is to be used to determine the portion of pre-tax income that may be offset for different percentages of stock ownership. Since existing Code Section 382(b) already has a stock ownership test, the proposal adds needless complexity. The proposal's limitation for the issuance of stock on a non-pro rata basis once again flies in the face of legislative efforts to simplify the tax law and lacks solid policy justification.

The general rules of the proposal create literally endless rounds of computations to determine limitations for all other carryovers. In short, the proposal would be a nightmare to tax practitioners attempting even a superficial analysis of the tax consequences of an acquisition.

RETENTION OF LOSSES AFTER CONVERSION OF ASSETS

The Subcommittee also invited comments on the specific issue of whether, where a loss corporation has converted operating assets to passive investment assets, the corporation should be entitled to retain its net operating losses. The net operating losses should survive because the policy underlying tax attributes is to match the attribute with the *entity* responsible for its creation.

Business realities will control the sale price of a loss corporation. In an arm's length transaction, the purchaser and seller of any business have a good grasp of the value of the business. The market price is simply the market price. Parties to an acquisition do not arrive at a purchase price, as the proposal presumes, based solely on tax attributes.

The proposal suggests that the loss valuation process and the tax benefit analysis are a stand-alone valuation technique, separate and distinct from the business considerations of an acquisition. They most assuredly are not. If enacted, the proposal will penalize a loss company by discouraging the continuation of corporate enterprises. Resulting unemployment from the collapse of a business can only mean a lower federal tax base. This unintended but detrimental consequence must be avoided.

APPLICATION OF CODE SECTION 269

From a policy standpoint, the goal of new legislation should be the protection of governmental interests without closing the door on all potential acquisitions. Mechanisms are already in place to discourage corporate tax avoidance in acquisitions. Code Section 269 restricts the carryover and use of tax attributes where tax avoidance is the principal purpose of an acquisition and expressly gives the Secretary of the Treasury broad discretion to disallow deductions, credits or other allowances.

Where Congress has enacted a specific provision, namely Code Section 269, whose sole function is to deal with tax avoidance, additional provisions to serve the same purpose are totally unnecessary. I urge the members of this Subcommittee to reject redundant measures which are legislative overkill.

SUMMARY

For the reasons outlined above, I recommend that:

The proposals being considered today be rejected;

The rules enacted under Section 382 in the Tax Reform Act of 1976 be repealed; and

Existing Section 382 be continued in its present form.

Mr. GUARINI. Thank you, Mr. McGrath.

Mr. Murphy who is with Jartran.

STATEMENT OF J. KEVIN MURPHY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, JARTRAN, INC.

Mr. MURPHY. Mr. Chairman, thank you for allowing me to be here today.

I am chairman and chief executive officer of Jartran, Inc., which is a Miami-based company engaged in the truck and trailer rental business. We employ some 500 people. We have annual revenues of approximately $95 million, and we operate in the 48 continental States.

This company has been in chapter 11 since December 1981. I guess, as a matter of protection, I will say that I came to the company 1 month later. Under court order, I became the chairman to run the company, to reorganize it, and take it out of chapter 11. We have an indebtedness of approximately $230 million, and operating losses of $105 million and ITC carryforwards of about $9 million. We anticipate and hope to come out of chapter 11 over the next few months.

My purpose in being here is to propose something to you that is quite different from what I have listened to today, and I apologize for that. Having experienced chapter 11 now, it is clear to me that many companies could be saved and could come out into the real business world if there was an ability to do something with their NOL's.

By that I mean, the ability to save jobs, in our case some 500 people, preserve the company, and keep operating. In the last 3 years some 50,000 American businesses alone have gone into chapter 11, of which only about 20 percent ever come out. The rest of them go chapter 7 liquidation or discontinue the process and disappear.

I am not here to represent anybody interested in using them for their bottom line purposes, but rather to preserve jobs. If you just assume that there are 20 employees per company, it is over a million jobs at stake. So, we are saying to the Congress, we hope that you might consider a company that is in chapter 11 having an opportunity to sell its NOL's.

In our own case, we have some 14,000 creditors, of which 13,000 have claims of less than $10,000. They are small business people. If the company disappears they also, as we heard a prior witness testify, wind up with a tax loss that they write off.

It might be suggested, Mr. Chairman, that this would have a negative impact on the Treasury. We don't believe that it is so, because you would preserve jobs, you would not have welfare and unemployment rolls expanding, cities and municipalities would be protected, and businesses would continue to function. Hundreds of thousands of creditors would be able to receive payment on their claims against the chapter 11 companies, and working capital would be developed.

At the time of the 1981 tax law debate there was a similar proposal concerning distressed companies, and that did not carry through the entire House, but we have taken some of the suggestions out of that proposed legislation, which was H.R. 4242, and sought to combine them in this recommendation that we have made to you, Mr. Chairman.

We are suggesting that this be a short-lived proposal of 2 years, that it apply to chapter 11 companies during the period of July 1983 to the end of December 1985, to allow them to sell the NOL with a cap on how much of it could be used over the 3-year period so that there was some control over it, and it couldn't be dropped on the Treasury all at one time. The chapter 11 company, of course, would have to survive and be in existence for at least 2 years beyond their discharge of bankruptcy. So, it isn't something that they just do and then disappear. It would be used so that the company had to survive and it had to continue to function in its business, so that the people who work for that company would continue to be employed.

At this critical time, with the high unemployment rate, I truly think that this proposal has strong merit. In our case, I know that working capital is vital to our company and its ability to survive and grow. It is a company that could, if it had working capital to do so.

In wrapping up my comments to you, I would like to ask you, Mr. Chairman, to consider the fact that not only jobs would be saved, but there are a lot of collective, bargaining agreements that are negated as a result of the chapter 11 process.

There are many companies now in chapter 11 that would be viable, but they go chapter 7 and are liquidated, and they disappear forever from the standpoint of NOL's, ITC, and so on, assets that could have been used to preserve those jobs and those companies in those communities. In your own State, for example, in the last 2 years there have been about 800 companies going to chapter 11. You have a situation where lots and lots of people have gone out of work as a result of it.

So, we would say to you, Mr. Chairman, this is an opportunity to consider helping distressed companies that are just emerging out of really dark economic days of one of the worse recessions our country has ever been in. The number of chapter 11's, hopefully, will subside and go to a much lower number, and this could be an interim measure to help protect jobs.

I thank you for the opportunity to present these thoughts.

[The prepared statement follows:]

STATEMENT OF J. KEVIN MURPHY, CHAIRMAN, JARTRAN, INC.

My name is J. Kevin Murphy. I am the Chairman and Chief Executive Officer of Jartran, Inc., a Florida corporation with its headquarters in Miami, Florida, and with regional offices in twelve major United States cities.[1] We employ 500 people, have annual revenues of $95 million and rent 11,000 trucks and 19,000 utility trailers in the 48 continental states. Our company has been in Chapter 11 since December 31, 1981. I became Jartran's Chairman in January 1982 pursuant to the order of Bankruptcy Judge Fisher. The Chapter 11 proceeding is taking place in the Northern Illinois Federal Bankruptcy Court in Chicago, Illinois. Jartran has obligations of approximately $230 million, net operating losses (NOLs) of $105 million and ITC carry forwards of $9 million. It is anticipated that our company will be coming out of Chapter 11 in the next few months.

My purpose in appearing before this Committee is to present a legislative proposal which would permit Chapter 11 companies to sell their net operating losses to the private sector and thereby obtain the working capital necessary to be discharged from Chapter 11 and be able to operate successfully. During the past three years, over 50,000 companies have gone into Chapter 11 because of the serious economic conditions which have gripped our country. Only 20 percent of Chapter 11 companies come out of Chapter 11 with the other 80 percent being liquidated under Chapter 7 or discontinuing operation. The net result has been the loss of hundreds of thousands of jobs, loss of income to hundreds of thousands of small creditors and severe adverse impact upon major cities in America where most of these companies are located. In our own case, we have almost 14,000 creditors of whom 13,000 have claims of $10,000 or less. If our company, and the thousands of distressed companies like us, are not able to raise the capital necessary to survive Chapter 11 and reenter the world of business, then tens of thousands of people will join the ranks of the unemployed with unfortunate results for major cities and small business creditors all over America.

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[1] Atlanta, Georgia; Boston, Massachusetts; Chicago, Illinois; Cleveland, Ohio; Dallas, Texas; Edison, New Jersey; Kansas City, Missouri; Los Angeles, California; Memphis, Tennessee; Philadelphia, Pennsylvania; and Portland, Oregon.

For those of you who were members of the Ways and Means Committee during the time of the 1981 tax law rebate, this proposal may have a familiar ring to it. If so, it is because I have borrowed the purpose and mechanics from part of the Ways and Means Committee bill that was not passed by the full House. I'm referring to the Distressed Industries Provisions in H.R. 4242 of the 97th Congress. Although that provision dealt with carryovers of Investment Tax Credits, I believe that the Committee's approach in those provisions is sound, its purpose practical, and for that reason used it as a model for suggesting to this Subcommittee that it consider amending the Internal Revenue Code along the lines of those distressed industry provisions in H.R. 4242, to permit qualified Chapter 11 companies to sell their only assets, their NOLs.

Our legislative proposal is this:

1. Permit Chapter 11 companies, during the period of July 1, 1983 to and including December 31, 1985, to sell all or part of their accumulated net operating loss carryovers.
2. The NOL sale would be required to take place prior to the end of the second year after the order of confirmation of the Bankruptcy Court has become final.
3. The Chapter 11 company would have to obtain a confirmed plan of reorganization between July 1, 1983 and December 31, 1985.
4. The Chapter 11 company would have to be operated for a minimum of two years after the order of confirmation is final in order for the purchased NOL to be usable.
5. The company acquiring the NOL would apply it over a period of not less than three taxable years, and the amount of NOL applicable in any one year could not exceed $25 million.
6. The Chapter 11 company would be required to use the proceeds of the sale of its NOL as working capital for continued operation of its business and/or purchase of capital items.

Many people might suggest that this could result in a loss of revenue for the Treasury. We submit that this is not an accurate position. Our country has never had as many bankruptcies as in the past three years. Companies that would ordinarily have survived and provided hundreds of thousands of jobs have either been extinguished or are now threatened with extinguishment. Hopefully, this period of jeopardy to jobs and businesses in America will subside in the near future, but in the meantime, it seems appropriate that we maintain as many people working as possible. Employed people pay taxes; they are not on the welfare or unemployment roles; and the companies for which they work continue to purchase goods and services from other companies and add to the tax base. The ripple effect of one Chapter 11 company going into liquidation under Chapter 7 is tremendous. As indicated earlier, we would have an impact on over 13,000 small businesses if that occurred to Jartran. It is our estimation that of the 50,000 companies that have entered Chapter 11 in the past three years, the approximate number of employees is at least 20 per company which means a million jobs are involved. We believe the positive preservation of jobs, payments to small business creditors and the assured revival of the troubled companies will more than offset the short term impact on federal revenue.

In our judgment, the following are amongst the many benefits that could be derived from such legislation:

assure continuation of jobs for hundreds of thousands of Americans employed by the distressed companies;

preserve collective bargaining agreements;

restore companies to viability through utilization of their own assets and by the private sector;

avoid government guarantees;

provide a means of self-help to companies that are victims of the unusual economic conditions of the past three years;

provide hundreds of thousands of small business creditors with the assistance they need to survive; and

protect government entities from losing revenues generated from employed taxpayers and operating businesses.

Over the next two years, our country hopefully will be emerging from the dark economic days of the past three years. This proposed legislation for distressed, while late in consideration in enactment, might be most helpful to our country as it emerges from the troubled times.

I thank you for the opportunity to be here today.

Mr. GUARINI. Is the thrust of your testimony that there ought to be two categories. One, special treatment of companies that have the criteria of being in chapter 11, and then the other category would be those who are not in chapter 11?

Mr. MURPHY. No, I was really only addressing chapter 11 companies.

Mr. GUARINI. Should there be a special provision for chapter 11 companies?

Mr. MURPHY. That was my proposal; yes, sir.

Mr. GUARINI. You are saying that there should be a special provision for chapter 11 companies.

Mr. MURPHY. Yes.

Mr. GUARINI. They should be treated differently than the ones which are not in chapter 11. There should be another carryback and carryforward for operating loss of companies that are in chapter 11.

Mr. MURPHY. I think what I am proposing is a little bit different. I am not a tax expert, Mr. Chairman, but it is really to permit chapter 11 companies to have the opportunity, if their asset base is such that the principal assets they have are NOL's, to be able to use those assets.

The company has to be found viable by the bankruptcy judge and an order of confirmation issued. So this would be integrated in part of that, or else they could not come out of chapter 11. The court must rule that you are a viable company before you can come out.

Mr. GUARINI. It is not difficult to go out of chapter 11 if you wanted to work it out with your creditors. I am just wondering whether or not there would be abuses in your suggestion.

Mr. MURPHY. Mr. Chairman, that would be a possibility, and I would think that the proper language could be put into such legislation to prevent that.

Mr. GUARINI. I agree that there should be some law for distressed industries. I was hopeful that there would be Reconstruction Finance Corporation that worked so well, a modernized something along the lines of what we had years ago which cost the Government no money. Instead of taking corporations like Chrysler and Lockheed by individual bills that we would have in place something that some of our industries, if they were distressed could come to.

I don't know whether or not the philosophy of the tax code should be used. I don't know that we should tax, otherwise dollars, to subsidize that kind of distressed companies, nevertheless, I thank you for your thoughts.

I just think that we should have a vehicle, but what that vehicle is is still under debate and discussion in Congress today in terms of whether or not it will be a finance reconstruction company.

Mr. McGrath, the Centel Corp., had 40 acquisitions in 5 years.

Mr. MCGRATH. Yes, sir. It is fairly active in growth in the telecommunications industry, including cable television.

Mr. GUARINI. Are all of the acquisitions in telecommunications?

Mr. MCGRATH. Yes.

Mr. GUARINI. You are not a diversified company?

Mr. MCGRATH. We are not a conglomerate, no.

Mr. GUARINI. Those acquisitions are in the line that you are operating?

Mr. McGRATH. They are of businesses that we operate and that we know.

Mr. GUARINI. Which are all in telecommunications?

Mr. McGRATH. Yes, all in telecommunications. To suggest that we would acquire a Jartran to get its NOL, is the trafficking in NOL's which everybody perceives, but I don't think that it exists.

Mr. GUARINI. You could pick up Jartran. [Laughter.]

Mr. McGRATH. We may have a discussion.

Mr. GUARINI. They could cart around your telecommunications equipment. Sometimes we make marriages.

Mr. McGRATH. I object to that kind of concept, that people suspect that we would go out and acquire a company simply because it has tax attributes. That is silly and naive, we acquire companies that we know, that we understand, and that we can operate.

Mr. GUARINI. Forty acquisitions in 5 years, it means that you have done 1 every 45 days.

Mr. McGRATH. I can't keep track of them anymore.

Mr. GUARINI. Do you think that if you spent more time in expanding your equipment and machinery that you would be productive in our society to a greater extent than when the board of directors, the chairman, and the chief operating officer of the company spend all this time acquiring other companies.

Mr. McGRATH. No. What tends to happen is that our acquisitions are in the cable TV area, which are franchised areas and there are only so many out there. If you want to be in the business, you have to acquire an existing one, or go out and bid for a new one. The cable TV industry has grown, and if you want to grow and stay with that growth, you have to acquire an existing company.

Mr. GUARINI. You don't pick up well companies. You pick up distressed companies that have losses that allow you to keep pyramiding what you are doing.

Mr. McGRATH. That have losses, that are financially troubled, that have been run by entrepreneur venture capitalists for a number of years and are financially distressed.

Mr. GUARINI. You have been here all day and you have heard people state that the section 382 has been arbitrary and has been criticized as being contrary to good tax policy. Do you have any feelings about that in view of the fact that you have been successful in what you are doing?

Mr. McGRATH. I think there is a policy reason for having the limitations, and there are limitations under the existing section 382 as well as existing section 269. There ought to be policy bars to tax motivated acquisitions. But we ought not to have these kinds of objective standards, which are so complex that no one in the room understands them, written into the statute.

Mr. GUARINI. Is it a policy that, if we do as you would suggest, it would increase the rapid rate of using these net operating losses and more or less encourage revenue losses which would be sustained as a result of the use of these losses, in a way subsidizing these companies by what otherwise could be revenues in our treasury?

Mr. McGrath. I don't think that there is a terrible loss to the fisc today. I don't think that existing section 382 or existing section 269 really are abused and cause a loss of revenues. All I am suggesting is to leave the status quo, and there is nothing wrong with that. If it ain't broke, don't fix it.

The proposal, the ALI proposal is so complex, that I think even the Treasury doesn't like portions of it. Why make it overly complex. There are other ways to do it. There are policy prohibitions in the statute.

Mr. Guarini. I want to thank you for the testimony that you have given us. Do you have anything else that you would want to add?

Mr. McGrath. No, thank you.

Mr. Murphy. No, thanks, I appreciate the chance that I had.

Mr. Guarini. Do you have anything that you want to say, sir, I noticed that you were moving forward when they were talking. If you want to put something on the record, this is your last chance.

Mr. Tomasulo. I was going to say that the public relations impact of this gentleman's suggestion would be pretty rough. If we say that we are going to let NOL's be sold by insolvent companies, that would be a hard thing to sell politically.

Mr. Murphy. I would beg to differ with you because of lots of reasons. No. 1, you do not have a situation where it wouldn't be that anybody could sell them. You would have to survive, you would have to stay alive for at least 2 years. You would have to have approval of the bankruptcy court to do it. Then they would have to satisfy themselves that you are viable.

It would preserve jobs. It would certainly help major communities all over America. We have had 50,000 businesses go into chapter 11 in the last 3 years. Hopefully that is not going to repeat itself.

Mr. Tomasulo. Making it temporary, of course, would help, and tough restrictions would help, but it still doesn't look easy.

Mr. Guarini. I thank you both for the benefit of your thoughts.

In our commodities market, you can now play and bet the Dow Jones, so maybe we might be able to find in the market an opportunity to put bids on net operating loss.

Mr. Duncan.

Mr. Duncan. I have no questions.

Mr. Guarini. Gentlemen, I thank you all. The hearing is adjourned.

[Whereupon, 4:10 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Bryan, Cave, McPheeters & McRoberts, St. Louis, Mo., Submitted by William D. Crampton and Edward J. Buchholz

The following statement is submitted to the Subcommittee on Select Revenue Matters, House Committee on Ways and Means, for consideration in conjunction with the other statements and comments submitted at the hearing before the Subcommittee on September 22, 1983:

In general, we endorse the views expressed in the statement of the New York State Bar Association, Tax Section ("NYSBA"). Our specific comments below elaborate on those of the NYSBA, and discuss certain additional points:

1. Deferral of effective date of any legislation concerning carryover of tax attributes.—We agree wholeheartedly with the NYSBA that the effective date of any new legislation should be delayed for up to one year (i.e., to January 1, 1985), and in our view for as long as 18 months, (i) to allow practitioners, bar associations and other interested parties sufficient time to evaluate closely the specific legislative proposal so as to minimize technical problems, and (ii) to allow the Treasury Department a minimum of one year in which to issue regulations. We believe that a sufficiently delayed effective date would help avoid many of the technical (and policy) issues that arose with respect to amended section 382 enacted by the Tax Reform Act of 1976.

During the interim, we suggest that existing section 382 continue in effect unchanged. It is our view that the Treasury would suffer little detriment from such a delay because current sections 382 and 269 already prevent most instances of loss trafficking.

Absent such a delayed effective date, we strongly recommend grandfathering under existing section 382 the treatment of loss corporations that are currently involved in bankruptcy proceedings. In certain cases, plans of reorganization which have taken many months to formulate have been proposed in reliance on the current version of section 382. Revising these plans now, irrespective of the availability of the tax attributes, would only needlessly extend the bankruptcy proceedings, thereby increasing the financial risks to the bankrupt corporation and its creditors and shareholders.

2. Soundless of overall proposal.—We support the concept of the proposal prepared by the Staff of the Joint Committee on Taxation (the "Staff") that net operating loss carryovers be used by the loss corporation to the same extent, as to both amount and timing, as the loss corporation could have used the carryovers absent a change of ownership. We strongly support the elimination of subjective tests, such as the change of business rule under present section 382(a), and we also welcome the proposals which amend the current rule of section 382(a) that results in arbitrary disallowance of net operating loss carryovers in certain non-abusive situations.

3. Undesirability of Purchase Rule.—We echo the suggestion of the NYSBA that the Subcommittee consider the possibility of a single limitation measured by the purchase price for the loss corporation, particularly in light of the potential complexity of the purchase rule. In our view, adoption of the purchase rule would be contrary to the tax policy of simplification and would only serve to substitute difficult questions of fact for difficult questions of law that exist under current section 382. Given the vast difference in acceptable rates of return for various types of businesses and the increasing presence of conglomerates, we question the suitability of substituting arbitrary rates of return for those of the market place.

Moreover, use of arbitrary rates of return on purchase prices could inadvertently result in ignoring the return provided by a corporation's intangible assets, particularly those not appearing on its financial records, e.g., patents, trademarks or goodwill. Basing a rate of return solely on the purchase price may result in a rule which is too favorable in some cases, too restrictive in others. For example, compare the following two situations where all the participating stock of the loss corporation is purchased: (i) the loss corporation purchases a new, profitable business, and (ii) the loss corporation sells an existing business to concentrate on the same business as in (i) but which in the hands of the corporation has only been marginally profitable. From a policy standpoint situation (ii) is clearly more attractive, yet the proposal would apparently allow the same amount of loss carryovers in both situations.

In addition to endorsing the NYSBA's comments, we have the following comments:

1. Relationship to cutback of attributes under provisions enacted by the Bankruptcy Tax Act of 1980.—It may be unfair to subject net operating loss carryovers to further reduction in situations where they have already been reduced significantly by application of section 108 of the Code or where the loss corporation has elected to reduce the basis of its assets in lieu of reducing tax attributes. While different policy considerations affect section 108, in our view, corporations that are involved in a bankruptcy proceeding and which become subject to that Code provision should not suffer the same reduction in loss carryovers under section 382.

2. De minimus provision in purchase and merger rules.—If the purchase rule is adopted, we support the existence of a *de minimus* provision such as the one proposed by the Staff whereby the purchase rule would not apply unless more than 50 percent of the outstanding participating stock changes ownership after a loss year. However, we suggest that the Subcommittee consider allowing some minimum percentage or amount of net operating loss carryovers without application of the limitations since recent legislation reducing taxes, particularly ACRS, may have contributed to the size of carryovers. To that extent and given the policy behind ACRS of encouraging capital formation our position is that the carryovers attributable to ACRS should be allowed irrespective of a change in ownership.

We believe that it would be appropriate for a *de minimus* provision also to apply to the merger rule. Thus, the Staff has reduced the percentage of the loss corporation's pre-tax income which a loss carryover may offset to a percentage less than the percentage of participating stock issued to the loss corporation (or its shareholders) to reflect the portion of the stock issued by the corporation for the tax attributes. Based on economic realities, we suggest that one technique for incorporating such a *de minimus* provision would be to increase above the current proposal the percentages of pre-tax income which can be offset by loss carryovers to take into account the fact that acquiring corporations generally do not value losses at an after-tax cost equal to 46 percent times the size of the loss. In many cases, a loss corporation's marginal rate of tax would be substantially less than 46 percent if it were profitable. In addition, loss carryovers, viewed as assets, will carry a substantial discount because (i) losses can only be used over lengthy future periods and (ii) doubt may exist as to the ability to prove the losses to the satisfaction of the Internal Revenue Service. We suggest that section 269 could continue to alleviate the Staff's concern that a purchaser will be paying primarily for a corporation's tax attributes.

3. Rate of return on preferred stock issued under the merger rule.—Under the Staff proposal, if the acquiring corporation issues only preferred stock with a market rate yield, the limitation on use of the loss carryover would be computed with reference to the amount of income needed by the corporation to pay the dividends on the preferred stock. We see considerable difficulty in applying this limitation since many issues of preferred stock are convertible into common, provide for redemption at a premium or contain other features compensation for a dividend rate lower than market.

4. Miscellaneous technical problems.—We recommend that the merger rule resolve favorably the issue of whether indirect ownership of the acquiring corporation may be taken into account in the case of a downstream transfer of assets. *See, World Service Life Ins. Co.*, v. *U.S.*, 471 F.2d 247 (8th Cir. 1973).

It is unclear under the Staff proposal whether an integrated two-step acquisition, such as a purchase of stock followed by an upstream liquidation (outside of section 338) or followed by a downstream merger would be covered by either the purchase rule, the merger rule or both.

DUANE, MORRIS & HECKSCHER,
Philadelphia, Pa., September 21, 1983.

JOHN SALMON, Esquire,
Chief Counsel, Committee on Ways and Means,
U.S. House of Representatives,
Longworth House Office Building,
Washington, D.C.

Re Proposal of the Subcommittee on Select Revenue Measures to Amend Section 382 of the Internal Revenue Code

DEAR MR. SALMON: As you know, the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has announced that it will hold hearings beginning on September 22, 1983, to consider proposed amendments to section 382 of the Internal Revenue Code. We assume that the effective date of the proposed amendments would not result in the application of the amendments to any case which would not be affected by the amendments to section 382 included in the Tax Reform Act of 1976. Because the September 9, 1983 release of the Subcommittee on Select Revenue Measures announcing the hearings and briefly describing the proposed amendments did not provide any specific information concerning effective dates for the amendments, we would urge the adoption of effective dates that would prevent the application of the proposed amendments to any transaction to which the amendments to section 382 included in the Tax Reform Act of 1976 would not apply.

Sincerely,

SHELDON M. BONOVITZ,
(For Duane, Morris & Heckscher).

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures,
Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR MR. STARK: On September 8, you announced hearings regarding the carryover of net operating losses and other tax attributions of corporations, to be held September 22. One of the major subjects of the hearing is whether I.R.C. § 382 should be revised to provide more rational treatment of net loss carryovers.

As we discussed yesterday, I am sympathetic to your desire to ensure that the provisions of the Internal Revenue Code reflect sound public policy. However, the Bank Board believes it is crucial that any revision of Section 382 should preserve the treatment of insolvent thrift mergers now codified at Section 382(b)(7)(B). That section affords rational tax treatment of net loss carryovers in the case of supervisory mergers of failing thrifts by providing that deposits in an acquired corporation which become deposits in the transferee are treated as stock of both corporations, and deposits in the transferee are treated as stock for this purpose. Because the thrift industry is overwhelmingly mutual in form, this treatment is essential to ensure that losses of weakened associations can be carried over to acquiring entities to the same extent that loss carryovers of other types of businesses can be transferred in tax-free reorganizations.

This tax treatment is vital because it would in most cases greatly reduce the cost of FSLIC's supervisory actions. In some cases, disallowing favorable treatment of net loss carryovers could cause the cost of FSLIC assistance to exceed the cost of liquidation, thus requiring by statute an otherwise avoidable liquidation. And while the current tax treatment helps avoid liquidation by fostering supervisory mergers, the tax expenditure is also more cost effective than either capital maintenance for thrifts, as provided in Title II of the Garn-St Germain Act, or increased FSLIC assistance in supervisory mergers to offset adverse tax effects arising from a transaction.

At a time of continued fragility in the thrift industry, we believe a limitation or repeal of Section 382(b)(7)(B) would have a very negative impact on the ability of the Bank Board to resolve the difficulties now facing savings institutions, and to operate in the most cost effective way to reduce the pressure on the FSLIC's financial resources, and to protect depositors in FSLIC-insured institutions. Indeed, it is my belief that the current law recognizes certain unique factors in the tax treatment of supervisory thrift mergers which are of public benefit regardless of the economic health of the industry. Repeal of this treatment would be very short-sighted because it would increase costs to the FSLIC, reducing the efficiency of the deposit insurance functions, for all future supervisory assistance.

Finally, I think it is very important to point out that we have encountered no abuse of this authority.

I have attached for your information a copy of a letter dated May 27, 1982, to you from then Chairman Pratt, addressing these issues in more detail. Please feel free to contact me or any of my staff if we may be of any further assistance to you in this matter.

Sincerely,

EDWIN J. GRAY, *Chairman.*

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., May 27, 1982.

Hon. FORTNEY H. STARK,
U.S. House of Representatives, Washington, D.C.

DEAR MR. STARK: On May 6, 1982, you introduced H.R. 6295, the Corporate Takeover Tax Act of 1982, Title III of which would amend present tax law concerning net operating loss and other carryovers. Title III would, apparently inadvertently, delete section 382(b)(7)(B) of the Internal Revenue Code of 1954, which was enacted last year by the Economic Recovery Tax Act of 1981 ("ERTA"), P.L. 97-34.[1] That section

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[1] Section 301(a) of Title III provides a new section 382. Although new section 382(f)(8) is identical to current section 382(b)(7)(A), current section 382(b)(7)(B) is deleted. That section currently provides as follows:

(7) SPECIAL RULE FOR REORGANIZATIONS IN TITLE II OR SIMILAR CASES.—For purposes of this subsection—

(B) In a transaction qualifying under section 368(a)(3)(D)(ii)—

Continued

affords special tax treatment of net operating loss carryovers in the case of supervisory mergers involving failing thrift institutions by providing that deposits in an acquired corporation which become deposits in the transferee are treated as stock of both corporations, and deposits in the transferee are treated as stock for this purpose. In addition, Title III would amend current continuity of ownership standards concerning the percentage of net operating losses that may be carried over in all mergers or reorganizations, including thrift supervisory mergers. I strongly believe that elimination of section 382(b)(7)(B) and application of H.R. 6295's continuity of ownership provisions to thrift supervisory mergers would not be in the public interest.

I am sympathetic to your desire to ensure that the net operating loss carryover provisions of the Internal Revenue Code reflect sound public policy. However, such amendments would have an extremely adverse impact on the ability of the Bank Board, as the operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC"), to resolve the severe difficulties facing the thrift industry. Specifically, the current tax treatment afforded thrift supervisory mergers provides a particularly cost effective means to avoid otherwise unnecessary liquidations of thrift institutions, to reduce the current pressure on the FSLIC's financial resources, and to protect depositors in FSLIC-insured institutions. At the same time, such exceptional tax treatment has not, to our knowledge, been abused.

A brief review of the history and rationale of section 382(b)(7)(B) appears useful. On July 23, 1981, I wrote a letter to Senator Rudy Boschwitz (enclosed), seeking his support for an amendment to H.J. Res. 266 that would resolve several technical tax issues that could otherwise hinder the effectiveness of the FSLIC's actions with respect to ailing insured savings and loan associations. Prior to ERTA, section 382 imposed limitations on the use of pre-reorganization net operating loss carryovers where shareholders of the acquired corporation were not shareholders of the surviving corporation in a merger or other reorganization. As a result, there were varying degrees of uncertainty concerning the tax-free reorganization status of various types of supervisory mergers, in particular, mergers of a mutual association into a stock association and mergers of a stock association into a mutual association. The amendment modified section 382 to ensure that losses of weakened associations could be carried over to acquiring entities to the same extent that loss carryovers of other types of businesses can be transferred in tax-free reorganizations.

As I stated in my letter to Senator Boschwitz, the importance of this tax treatment is that it would in most cases significantly reduce the cost of supervisory activities of the FSLIC. Indeed, in some instances, the increased cost of FSLIC assistance, arising, for example, from disallowance of favorable tax treatment of net operating loss carryovers, could cause the cost of FSLIC assistance to exceed the cost of liquidation, thus requiring by statute an otherwise avoidable liquidation. It should be noted in this regard that, to the extent that such favorable tax treatment fosters supervisory mergers of failing thrifts, such tax expenditure is more cost effective than either capital maintenance for thrifts, as embodied in various proposals currently before the Congress, or increased FSLIC assistance in supervisory mergers. In short, my letter to Senator Boschwitz stated my strong belief that the Internal Revenue Code should reflect the extraordinary nature of thrift supervisory mergers, including affording special treatment for net operating loss carryovers of troubled thrifts.

Significantly, there is clear and abundant legislative history, illustrating Congress' intent that special tax treatment be afforded to thrift supervisory mergers in order to resolve troubled thrifts' problems and avoid liquidations. For example, the general explanation of ERTA states as follows:

> The Congress believed that recent economic conditions, including high interest rates, have had particularly adverse effects on the country's thrift institutions, which have been the primary providers of mortgage credit . . . . The recent high interest rates have required the thrift industry to pay high short-term rates to depositors; at the same time, substantial portions of mortgage portfolios consist of mortgages paying much lower rates. The resulting losses have threatened the viability of thrift institutions.

(i) A depositor in the transferor shall be treated as a stockholder immediately before the reorganization of the loss corporation,

(ii) Deposits in the transferor which become, as a result of the transfer, deposits in the transferee shall be treated as stock of the acquiring corporation owned as a result of owning stock of the loss corporation, and

(iii) The fair market value of the outstanding stock of the acquiring corporation shall include the amount of deposits in the acquiring corporation immediately after the reorganization.

> . . . . [T]he only way to maintain these organizations may be to merge financially troubled institutions into stronger institutions . . . .
>
> *The Congress concluded that the tax laws should be modified to facilities . . . mergers of financially troubled institutions into stronger ones.*

General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97th Congress; Public Law 97-34), prepared by the staff of the Joint Committee on Taxation, pp. 151-52 (emphasis supplied).

Senator Boschwitz's statement on the Senate floor introducing last year's amendments similarly illustrates Congressional intent that supervisory mergers of thrifts be afforded favorable tax treatment:

> This amendment would facilitate the infusion of capital to a failing savings and loan or the merger of a savings and loan with another financial institution by clarifying that these transactions are nontaxable events.
>
> The other alternative to capital infusions or mergers in the case of a troubled savings and loan would be liquidation by the Federal Savings and Loan Insurance Corporation.
>
> This would require payment out of their insurance funds to all insured depositors and would have *unfortunate results for non-insured depositors. The potential cost to the Government, depositors and shareholders could be significant.*
>
> Under current law, there is some uncertainty about the consequences of . . . mergers of savings and loans. *This uncertainty deters potential investors and will likely result in the more costly liquidation pay outs by the FSLIC.*
>
> . . . *[S]urely a merger of a failing savings and loan serves the public interest better than liquidation.*

127 Cong. Rec. S 8288 (July 23, 1981) (emphasis supplied).

The rationale for exceptional tax treatment of supervisory thrift mergers remains compelling given thrifts' current earnings crisis. Indeed, because the thrift industry's condition has severely deteriorated since enactment of ERTA, section 382(b)(7)(B) treatment for thrift supervisory mergers is perhaps more justified and necessary today than it was last year.

Finally, to reiterate, please be advised that we have encountered no abuse of this authority. By their nature, supervisory thrift mergers do not present significant problems with respect to tax-motivated takeovers or trafficking in loss companies, which your revision of current law is designed to address. Moreover, the Conference Committee report clearly states the conferees' intent that the requisite certification for the tax-free reorganization and net operating loss carryover treatment set forth in Public Law 97-34 not be made where it is determined that the association has intentionally placed itself in the position where one of the grounds for certification would otherwise apply. S. Rep. No. 97-176, 97th Cong., 1st Sess. at 284.

My second concern with H.R. 6295 is that it would amend the current continuity of ownership standards. These requirements determine the percentage of net operating losses that may be carried over in all mergers or reorganizations, including thrift supervisory mergers. Under current law, loss company shareholders must retain a *20* percent interest in the acquiring association in the carryover year to maintain the full loss carryovers of the loss company, with carryovers reduced by 5 percent for each one percentage point by which the loss company shareholders' interest falls below 20 percent. Under H.R. 6295, however, loss company shareholders must retain a *60* percent interest in the carryover year to maintain the full loss carryovers of the loss company, and carryforwards would be reduced by 2.5 percent for each one percentage point by which the loss company shareholders' interest falls below 60 percent.

The proposed percentages as applied to deposits, including passbook accounts, appear to be unrealistic and unfair in the context of thrift supervisory mergers. Because such mergers, by their nature, normally involve matching a healthy institution with a troubled institution, the retained percentage requirements would generally severely limit the amount of loss carryovers available from the failing thrift. Application of these percentage requirements to thrift supervisory mergers would effectively eviscerate section 382(b)(7)(B), thereby frustrating the important public policy goals which that section was designed to foster.

In closing, I am confident that the tax treatment currently afforded thrift supervisory mergers continues to serve the public interest. Please feel free to contact me or any of my staff if we may be of further assistance to you in this important matter.

Sincerely,

RICHARD T. PRATT, *Chairman.*

Enclosure.

LAW OFFICES OF
PETTY, ANDREWS, TUFTS & JACKSON,
San Franciso, Calif., September 14, 1983.

JOHN SALMON, Esq.,
Chief Counsel, Committee on Ways and Means,
U.S. House of Representatives, Longworth Office Building, Washington, D.C.

Re Proposed Revisions to IRC § 382

DEAR MR. SALMON: Comments have been requested regarding the proposed revision of section 382 of the Internal Revenue Code which will be considered on September 22 by a House Ways and Means subcommittee. Two alternatives which reportedly will be discussed at the hearing are the extension of the effective date of the propcsed amendments to section 382 and the repeal of such amendments in favor of existing section 382. The purpose of this letter is to suggest two revisions to existing section 382 which should be considered in the event that either of the foregoing alternatives is chosen.

Present section 382(a)(1) applies only upon the "purchase" of the stock of a loss corporation. For this purpose, section 382(a)(4) defines the term "purchase" as:

> [T]he acquisition of stock, the basis of which is determined solely by reference to its cost to the holder thereof, in a transaction from a person or persons other than the person or persons the ownership of whose stock would be attributed to the holder by application of [section 382(a)(3)].

Section 382(a)(3), in turn, provides:

> Section 318 (relating to constructive ownership of stock) shall apply in determining the ownership of stock, except that section 318(a)(2)(C) and section 318(a)(3)(C) shall be applied without regard to the 50 pecent limitation contained therein.

The combined effect of the above-quoted provisions may substantially emasculate present section 382. Although numerous examples are possible, consider the following: Individual A owns all of the stock of loss corporation B. A desires to sell all of B's stock to corporation C, which does not intend to continue B's business. Absent further facts, B's net operating loss carryovers (and other tax attributes described in section 383) would be eliminated under section 382(a)(1) as a result of this sale. However, if prior to the sale A held a portion of C's stock section 382(a)(1) would literally not apply. This is because 100 percent of A's stock ownership would be imputed to C under section 318(a)(3)(C) (as revised by section 382(a)(3)) and, consequently, C's acquisition of the B stock from A would not constitute a "purchase" within the meaning of section 382(a)(4).

Alternatively, assume that C is B's trade creditor and C also holds a portion of B's stock. Would a swap by C of B's trade debt for newly-issued B stock constitute a "purchase" for purposes of section 382(a)((1)? Presumably not, because under section 382(a)(3) C's prior stock interest in B would cause a portion of any stock owned by B to be attributed to C, thereby precluding the possibility of a "purchase" under section 382(a)(4).

Alternatively, if C acquires all of individual A's stock in B for cash, would such acquisition constitute a "purchase" if A had previously granted to C an option to purchase ten percent of such stock? It appears not, since under section 382(a)(4), A would arguably be "a person . . . the ownership of whose stock would be attributed to C." I.R.C. § 318(a)(4).

These untenable results underscore the need for a legislative amendment to sections 382(a)(3) and (4). While many of these problems could most likely be addressed on a case-by-case basis by the courts, with the assistance of the Treasury regulations (see, *e.g.*, Treas. Reg. § 1.382(a)1(e)(2)), it appears that a legislative revision would best solve the problem.

Please call me if you have any questions.

Very truly yours,

EMIL G. PESIRI.

HAYNES AND BOONE,
ATTORNEYS AND COUNSELORS AT LAW,
Dallas, Tex., September 29, 1983.

Mr. JOHN SALMON,
Chief Counsel, Committee on Ways and Means,
U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: I am a partner with the Dallas law firm of Haynes and Boone and my practice consists entirely of bankruptcy and insolvency matters. I am in charge of the bankruptcy group at our firm. I am chairman of the Tax Subcommittee of the Business Bankruptcy Committee of the Corporation, Banking and Business Law Section of the American Bar Association, a member of the Creditors' Rights Committee of the Litigation Section of the American Bar Association, chairman of the Tax Subcommittee of the Bankruptcy and Reorganization Committee of the Corporation, Banking and Business Law Section of the Texas Bar Association and chairman of the Tax Committee of the Dallas Bar Association's Section on Bankruptcy and Commercial Law. I have taught creditor's rights at Southern Methodist University School of Law and have authorized several articles regarding the interface between bankruptcy and tax law. The positions expressed herein are taken solely as an individual and not as the representative of any of the above mentioned organizations but with substantially unanimous concurrence of the members of the various committees set forth above.

This letter is intended to serve as written testimony on the proposed amendment to Section 382 of the Internal Revenue Code of 1954, as amended (the "Code") which proposal was the subject of a hearing held by the Select Revenue Measures Subcommittee on September 22, 1983. I believe that the proposed amendment and its limitations imposed on net operating loss carryovers will be extremely detrimental to debtors in bankruptcy cases. These limitations will severely restrict the ability of a debtor corporation to negotiate with its creditors and successfully rehabilitate.

The ability of a debtor in a rehabilitation case to pay its pre-petition debts is directly dependent upon its future cash flow. Eliminating a tax loss carry forward and other tax attributes reduces that cash flow. The reduced cash flow does not allow the debtor to pay its pre-petition creditors as much as it would otherwise be able to pay. Consequently, reduction of tax loss carry forwards does not just hurt the debtor, but takes money out of the creditors' pockets. In addition, reduction of net operating loss carry forwards will not result in greater revenues for the treasury since collections resulting from such reductions will be offset, dollar for dollar, by greater bad debt losses taken by pre-petition creditors.

The current proposal will seriously limit the effectiveness of the reorganization provisions of the Bankruptcy Code and is inconsistent with the basic purposes of a bankruptcy reorganization case. Since the purpose of the tax loss carryover provisions is to mitigate the adverse affect of the annual accounting period concept, to require the debtor to pay additional taxes on postpetition income prior to the payment of trade and other creditors is inconsistent with the tax loss carryover philosophy. Reduction of net operating loss carryovers would mean that less funds would be available for payment to creditors. Successful rehabilitation of debtors, which results in additional tax revenues from the elimination of bad debt losses by creditors, taxes paid by parties employed by the rehabilitated debtor, and additional income taxes paid in the future by the rehabilitated debtor would be impeded.

A bankruptcy is a disaster. It often means that people will lose their jobs, that creditors will go unpaid, that suppliers of the bankrupt entity may find themselves in financial difficulties. The financial problems of a bankrupt business entity extend far beyond the debtor itself. Consequently, the Bankruptcy Code provides for two types of bankruptcy proceedings for the business debtor. The first alternative is a Chapter 7 case where the assets of the debtor are liquidated by a trustee and distributed to the creditors of the debtor. The second alternative is a reorganization case under Chapter 11 of the Bankruptcy Code. In a reorganization case, the debtor is encouraged to rehabilitate by formulating a plan of reorganization to provide for the payment of all or part of the obligations owing to the creditors of the debtor. Often, creditors are paid a percentage of their claims or issued stock or other securities in exchange for all or a portion of their claims. Frequently, third parties acquire control of the debtor in order to provide the additional capitalization and management which are necessary for the rehabilitation of the debtor and payment of its creditors.

In addition to the amounts received by creditors in connection with reorganization cases, a Chapter 11 affords creditors and other parties in interest an opportunity to supply additional goods and services to the rehabilitated debtor. It offers employees of the debtor an opportunity to retain their jobs. Finally, it affords the Internal Revenue Service, and other taxing authorities, a viable, economic entity that will hopefully make profits in the future and pay taxes upon those profits. In short, the purpose of a Chapter 11 reorganization case under the Bankruptcy Code is to provide the debtor with a fresh start, to provide creditors with an opportunity to recoup their claims, to provide suppliers with an ongoing entity which will purchase goods and services, to provide employees with continued employment, to provide the community with a viable economic entity and to provide taxing authorities with a rehabilitated debtor, capable of earning profits and paying taxes.

A rehabilitated debtor provides a ripple affect and generates significant positive contributions to the community and to the economy in general.

The purpose of the tax loss carryover provisions is to prevent the taxpayer from being penalized for the timing of its income. The carryover provisions also recognize that losses in a particular taxable year should be recovered before the debtor is required to pay taxes on income which offsets such losses. In a bankruptcy reorganization context, such losses have often resulted in the inability of the debtor to pay its creditors. To require the debtor to pay additional taxes on post-petition income until such creditors are paid would be inconsistent with the purposes of the tax loss carryover provisions, since the debtor has not yet achieved a breakeven position. It can be safely stated that even more than the shareholders, the creditors of a corporate debtor have contributed to the creation of the corporation's net operating losses. There is absolutely no rational reason to elinimate all or part of the net operating loss carryovers of a corporate debtor until creditors are paid in full. A change of ownership of the stock of the debtor corporation is absolutely unrelated to the actual utilization of the net operating loss carry forwards.

I was involved in a recent Chapter 11 case which represents a good example of the utilization of net operating losses for the payment of creditors. In that case a manufacturing corporation with plants in several different states and several thousand employees was forced to file a Chapter 11 reorganization case. The debtor was a subsidiary of a large manufacturing organization engaged in multiple lines of business which was also required to file for relief under Chapter 11 of the Bankruptcy Code. Little if any equity existed in the debtor corporation as a going concern and a liquidation analysis indicated that creditors would receive less than ten cents on the dollar in a liquidation. A third party was located to purchase the stock of the debtor for a nominal amount, infuse necessary capital and management to the debtor and negotiate a plan of reorganization with the creditors. A significant net operating loss was available for utilization by the debtor. As a result of negotiation between the debtor and the creditors' committee, the cash flow generated from the future operations of the business and the utilization of the net operating losses provided enough cash flow to pay a significant amount to unsecured creditors. Under the current proposal, since a nominal price was paid for the stock of the debtor the net operating losses would have been severely reduced or eliminated. If the proposed amendments to Section 382 had been in effect at the time of the reorganization of this debtor, the creditors of the debtor would have received a significantly reduced payment. The proposed amendment to Section 382 would limit the availability of the net operating losses to the extent of a specified rate of return times the price paid for the stock of the debtor. There is absolutely no rational relationship between the price paid for a debtor's stock, the generation of net operating losses and the inability of the debtor to pay its creditors which bear the brunt of those net operating losses.

Financially troubled debtors often have little or any equity available for stock holders. Consequently, in an insolvency or bankruptcy case any price paid for the stock will usually be nominal. The adoption by Congress of any amendment to Section 382 which would reduce or eliminate net operating losses on the basis of changes in equity would be irrational and detrimental to the creditors which should benefit from such net operating losses. The preceived abuse of net operating losses by Congress does not exist in connection with financially troubled debtors since the real economic benefit of net operating losses accrues to the creditors of the entity which incurred those losses. Section 382, as in effect for taxable year 1982, achieves the appropriate result and should not be amended to penalize financially troubled corporations.

Many of these issues were debated in connection with the Bankruptcy Tax Act of 1980 which was ultimately passed by Congress and signed into law by the President. The Bankruptcy Tax Act of 1980 specifically provided for reorganizations pursuant to Section 368(a)(1)(G) of the Code and the transfer of net operating losses and other tax attributes to third parties in connection with bankruptcy and insolvency cases. The proposed amendment to Section 382 would eliminate the effectiveness of the "G" reorganization provided for by the Bankruptcy Tax Act of 1980. Since relatively few "G" reorganizations have yet occurred no one possesses sufficient experience to determine if the provisions of the Bankruptcy Tax Act of 1980 have been abused. These provisions, which were debated at length, should not be effectively repealed by the proposed amendment based upon the insufficient data which is currently available.

As a final matter, the subcommittee invited testimony on the question of whether a loss corporation which has converted operating assets to passive investment assets should be able to retain its net operating losses. For many of the same reasons discussed above, the net operating losses should be utilized for the benefits of the creditors of an insolvent debtor or a debtor in connection with a bankruptcy case. Consequently, such losses should remain in existence and be available to offset future income produced by the reorganized debtor for the benefit of its creditors.

Rehabilitated debtors pay taxes. Employed people pay taxes. Creditors who receive a greater percentage of their claims because cash flow is available for such payments pay taxes on such income and do not take bad debt losses. Ownership of stock of the debtor is normally substantially irrelevant in an insolvency situation and creditors of an insolvent debtor or a debtor in connection with the bankruptcy rehabilitation, should not suffer from actions involving transfers of stock since such transfers are unrelated to the creditors which bear the brunt of the losses which result in net operating loss carry forwards and who should receive the benefit from the cash flow generated by such carryovers.

It is my opinion that the position set forth above will foster rehabilitation of debtors with minimum negative impact upon tax revenue. I want to thank you for your cooperation in connection with this matter and if you have any questions or comments, please do not hesitate to contact me at the address set forth above.

Sincerely,

Robin E. Phelan.

Statement of Donald Schapiro, Esq., Barrett, Smith, Schapiro, Simon & Armstrong, New York, N.Y.

I am a practicing lawyer in New York City and submit this statement in response to the Subcommittee invitation to comment on the specific proposal as to net operating loss carryovers contained in the announcement of hearing (the "Subcommittee proposal"). My statement adopts the position that the existing rules of code section 382 should be retained (that is, that the effective date of code amendments should be delayed) for a further period pending additional study and consideration of the Subcommittee proposal.

For the reasons explained below, I do not believe the Subcommittee proposal, if adopted, will in fact conform with the stated rationale "that the net operating loss carryovers of a loss corporation should be available, both in amount and timing, to new owners as they would have been had there been no change in ownership and had the loss corporation invested its assets in an income generating activity". Specifically, the Subcommittee proposal (a) would limit net operating losses when the stock of a loss corporation is sold for cash even though it would have earned the same income in the hands of its former owners, thus actually restricting the availability of loss carryovers on a transfer of corporate stock, and (b) would not restrict corporate losses if the existing corporate owners provided new funds to the corporation to generate additional income, and accordingly does not limit losses even where the assets of the loss corporation which can be used to produce income have been augmented.

Further, as explained below, the Subcommittee proposal raises issues of economic equity since it would tend to discriminate against closely held or small corporations which may not have the resources to generate income to absorb losses, while the large corporate aggregation of capital can normally absorb losses in the current year (or as carrybacks) against income from other activities.

Finally, the Subcommittee proposal contains areas of complexity which deserve to be thought out more fully, particularly in their interrelationship with other code provisions.

GENERAL OBSERVATIONS ON NET OPERATING LOSSES

1. Where a corporation has unused net operating loss carryovers ("NOLs"), globally viewed, there has been a benefits transferred from the taxpaying group as a whole to the fisc, since the value of loss could have produced an immediate tax benefit:

(a) as an offset in a consolidated return;

(b) as a carryback against the corporation's own income;

(c) by way of application against shareholders' income if the corporation were an S corporation;

(d) by way of application against the income of corporate or individual partners if the loss had been incurred by a partnership.

In a sense then, the fisc has become enriched, at least for a period of time, because the loss did not reduce overall tax liability in the year the loss was incurred.

2. If we accept the existence of unused NOLs as an accident of fate enriching the fisc, we must also recognize that such accidents fate will continue to occur in the future, because here, as elsewhere, accidents will happen.

3. The question to be considered, then, is what rules should be applied in the tax law as to allowing the benefit of the NOL to produce a tax saving in some future year for someone, be it the entity or economic unit which suffered the loss of some other economic group. In answering this question, there are at least two policies which have validity, although they often lead to inconsistent results.

(a) The first policy is that the NOL should not be totally disregarded in the tax system (that it should not suffer immediate accidental death) and that at a minimum, an economic unit incurring an NOL should have some opportunity to recapture the benefit of the NOL in the future. This policy underlies allowance of NOL carryovers as a deduction at least where the same economic group continues the same business without additional investment. Let us call the first policy the policy of "Loss-Survival".

(b) The second policy is that the benefit of one economic group's NOLs should not be freely transferable to a wholly different economic group operating a different business. This policy, which we will call the policy of "No-Free-Portability", prevents the loss from being completely portable. The underlying reason behind this policy is that to permit a profitable entity to purchase existing tax losses is to allow "tax avoidance or evasion" because relief from taxes ought not to be available for purchase on the open market.

4. The chief problem in drafting rules for NOLs is that the Loss-Survival policy is inconsistent with the No-Free-Portability policy in cases where the economic unit which suffered the loss wishes to transfer the value of the loss to others who may be able to utilize it more efficiently, either in the business which created the loss or in some other business.

5. It is consistent with the policy of Loss-Survival to permit the former owners of the economic unit to recover the current value of the NOL by way of a sale or transfer of some part or all of the corporate entity housing the loss. After all, the original economic group suffering the loss had the misfortune not to be able to utilize the loss when it was incurred (as it might have in other circumstances (see par. 1 above)), so why not permit them to realize its value without requiring them to keep owning and operating the entity which incurred the loss.

Substantial economic arguments can be made to support the policy of Loss-Survival with totally free loss portability:

(a) There is no economic reason to favor large aggregations of capital to conduct venture type activities which are likely to produce losses. Yet these large aggregate capital do not face the problem of unused NOLs because current losses can be offset against other unrelated income of the group, for example, in a consolidated return. Nor is there any reason to force venture type activities within the mold of subchapter S corporations or partnerships so that current losses can be offset against other income. Indeed, it can be argued that competition sharpens, and the free enterprise system benefits by encouraging small capital pools to be organized for venture type activities. Loss survival and free portability would represent tax neutrality as to such capital formations.

(b) There is no economic reason to render the entity having incurred the loss less valuable in the hands of others who may be able to manage it better than in the hands of the former owners. Yet, if the NOL is reduced or eliminated on a transfer of entity ownership, the tax law tilts in favor of leaving the entity in the hands of the former owners. Indeed, it can be argued that our tax system should at least be neutral as to selecting the ownership and management of our productive resources, and the tax law should not discourage free transferability of such resources.

6. It is probably fair to say that under the existing tax rules, the policy of No-Free-Portability is not supported principally because of its revenue impact. As noted above, the very existence of unused NOLs is an accidental benefit to the fisc. If it were desired to enhance revenues by stamping out the survival of NOLs in all cases, the Congress could easily draft a statute eliminating loss carryovers in all cases. Rather, it seems clear from the existing statutory provisions embodying the policy of No-Free-Portability, that sections 269 and 382 are directed mainly against the perceived evil of opening up a free market in "tickets to avoid tax".

7. Present law, then, generally favors Loss-Survival and portability, and applies the policy of No-Free-Portability only to a relatively few cases. Moreover, section 269 contains a general and difficult to administer anti-tax avoidance or evasion policy.

8. One often hears it said that the existing tax rules for NOLs are unsatisfactory and difficult to administer. The mere assertion of this point of view does not, however, make it correct. It might equally well be said that the present rules on NOLs are working very well indeed in accomplishing the purpose of favoring Loss-Survival but keeping some restrictions on cases which might generally be perceived as an

"abuse". The Subcommittee proposal would generally change existing law by strengthening the policy of No-Free-Portability at the expense of policy Loss-Survival. While some transfer of NOLs may be permitted under the Subcommittee proposal which would not be allowed under existing law, the general trend is in the other direction. Thus, one of the issues to be considered in evaluating the Subcommittee proposal is the desirability of changing the existing tilt between the policy of Loss-Survival and the policy of No-Free-Portability.

9. Suggested changes in the tax law should be carefully examined for likely problems of interpretation, possible administrative inconvenience, and complexity. Many proposals for new rules which appear, on first consideration, to be fair and desirable must be rejected or significantly changed on analysis because they are unworkable in practice or create other major problems. The existing rules on NOLs, apart from their perceived merit or lack thereof, have been in force for sufficiently long so that the tax bar and the Revenue Service understand them, and are aware of their problems. Their defects are at least not latent.

SPECIFIC COMMENTS

The examples below are all based on variations of a single hypothetical case in which a corporation (L Co. not electing under Subchapter S) is organized in years 1 by a single shareholder ("S"). L Co. breaks even in year 1, and has a net operating loss of $1,000 in year 2, which is an available carryover in subsequent years.

Example 1.—Assume that L Co. has profits in year 3 of $1,000. There has been no change in ownership or new investment.

Under both existing law and the Subcommittee proposal, the NOL would be unaffected and available to offset the $1,000 profit in year 3.

Example 2.—Assume that S sells all the shares in L Co. to T (unrelated) at the start of year 3 for cash. The business of L Co. is continued and it has $1,000 profit in year 3.

Under existing law, section 382(a) would not apply because of no change in business, so the issue would be the application of section 269. Under the Subcommittee proposal utilization of the loss would be restricted.

If we assume that T would prevail under section 269 under existing law, does the Subcommittee proposal lead to a sound result on the facts assumed? What would be the result under the Subcommittee proposal if T had purchased the L Co. shares in year 1? in year 2? Can differences in treatment between these purchases in different years be justified in all circumstances?

If there was a "built-in gain" of $1,000 when T acquired the L Co. shares at the start of year 3, it appears that the NOL would be available without restrictions under the Subcommittee proposal. Suppose, instead, there is no specific built-in gain in L Co. assets but business prospects were sufficiently favorable to produce a high likelihood that L Co. would have income of $1,000 in year 3 whether or not its shares were transferred by S to T. How would the Subcommittee proposal operate in this case?

If there were built-in losses in L Co. in year 1, it appears that a purchase by T of the L Co. shares in year 1 might cause the loss limitation rules to be applied. Would built-in deductions in a loss company include poor business prospects as well? Would the Subcommittee proposal retain the concept of limiting deductions if the principal purpose of the transaction was the "evasion or avoidance" of federal tax as in present section 269?

Example 3.—Assume that at the start of year 3 L Co. issues additional shares of common stock for cash to T (unrelated to S), constituting 49 percent of total outstanding shares.

There would be no curtailment of the NOL under present law since T acquired less than 50% of L Co. shares. Neither section 269 or 382(a) would be applicable. Under the Subcommittee proposal, only about 35% of L Co.'s income could be offset by the NOL. Is this appropriate as a matter of tax policy? How would the Subcommittee proposal operate if, instead of acquiring shares of L Co., T had purchased convertible debt of L Co., or had made a straight loan to L Co. and, in addition, received an option to purchase L Co. shares from L Co.? or an option to purchase such shares from S? Note that if S instead of T had made the stock purchase in L Co., there would be no curtailment of the losses under the Subcommittee proposal.

Example 4.—At the start of year 3, either stock or assets of L Co. are acquired by X Corp. or a subsidiary of X Corp. in a tax free reorganization for common stock representing 25 percent of X Corp.'s outstanding stock after the reorganization.

Under existing law, section 382(b) would be inapplicable, and section 269 could be applicable depending on tax avoidance motive. Under the Subcommittee proposal, if

L Co.'s assets were acquired by X Corp., then the L Co. loss could be offset only against about 15% of the aggregate income of X Corp. How would the income to which the 15% is to be applied be measured if X Corp. had subsidiaries and was not filing a consolidated return? Would the application of the Subcommittee proposal rules depend on whether L Co.'s assets wound up in a subsidiary of X Corp.? What would happen under the Subcommittee proposal if the shareholder of L Co. was to receive a contingent number of X Corp. shares in the reorganization?

In addition to the matters discussed above, the following matters should be considered in connection with the Subcommittee proposal:

(a) Rules are provided for shares of stock of an acquiring corporation which are either straight common stock (fully participating) or straight preferred stock (preferred and limited as to dividends). What rules would be applied to hybrid shares?

(b) Where shares of a loss company are sold for a consideration other than cash, a valuation of the consideration would appear to be required. How would the provision operate if the buyer bought the shares of the company for notes which are reported on the installment basis by the seller and for which no fair market valuation would otherwise be required. It appears that a valuation of shares of stock received for loss company shares would also be required where the loss company becomes a subsidiary of the acquiring company even though the transaction is a tax free reorganization for other tax purposes, and no valuation of the shares received would otherwise be required.

CONCLUSIONS

In my view, the merit of substituting the Subcommittee proposal for present law has not been established. Apart from the policy question whether the Subcommittee proposals are better tax policy than existing law, the Subcommittee proposal appears to contain many latent problems. As pointed out above, they require that valuations be made where none are now required; they present difficult issues of defining built-in-gains and losses; and while presumably contemplating the repeal of section 269 as applicable to NOLs, they appear to leave many problems to solutions based on principles of "tax avoidance." Accordingly, present law should be retained for the time being while the Subcommittee proposal, as well as other possible solutions, are further studies and considered.

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